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Credit Rating Agencies: Regulatory changes and market participants' perspectives

By

Tabani Ndlovu

A thesis submitted in partial fulfilment of the requirements of the award of Doctor of Philosophy

Faculty of Business
Oxford Brookes University

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Abstract

The lack of regulatory oversight on Credit Rating Agencies (CRAs) has for a long time been viewed as an anomaly, particularly as CRAs were perceived to wield unfettered power, sanctioning the flow of funds between investors and borrowers in global securities markets. The regulatory void was in contrast to the heavy reliance on credit ratings by regulators in determining minimum capital adequacy requirements for banks and other depository institutions. CRAs and other information intermediaries were said to have failed in their information intermediary roles, possibly causing various corporate collapses and exacerbating calls for regulation. Various scholars and practitioners argued that the lack of CRA regulation caused a number of legacy problems which allegedly compromised CRAs' objectivity and independence in their information intermediation roles in the global securities market. The commonly touted legacy problems included lack of competition in the ratings market; conflicts of interest arising from the issuer-pays model; opaque rating methodologies as well as lack of accountability among CRAs. Following the 2007-8 global financial crisis where CRAs allegedly failed to provide timely rating adjustments to deteriorating securities, the European Commission (EC) gazetted the 2009 regulations to stem the legacy problems in CRA operations and prevent further crises in the European Union (EU). Rather than quell concerns on the operations of CRAs, the new regulations triggered further academic debates regarding their motivations, purpose, impact, timing and effectiveness. It was not clear whether practitioners working with credit ratings shared the emerging concerns. This study was conducted to gauge the views of practitioners working with credit ratings on the perceived impact of the EC regulations. The study took an interpretivist approach, employing semi structured interviews. Study participants were initially selected purposively and subsequently snowballed from four groups comprising issuers, institutional investors, CRAs and Other Interested Parties. The study adopted a metaphorical data analysis approach, using the endogenous regulation theory to conclude that there was a disconnection between the regulators and those regulated. It was noted that some regulatory conceptions lacked practical relevance and could detrimentally affect market operations. The study made various contributions to practice, theory and literature. It recommended an endogenous and more inclusive regulatory approach, fostering closer cooperation between regulators and those regulated, particularly in a tightly-closed industry where those regulated possessed more information regarding the technical nature of the industry than regulators.

Key words:
Credit rating agencies, regulation, securities regulation, financial crisis, metaphor analysis, endogenous regulation, social constitution of regulation

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List of abbreviations and acronyms

ACT	Association of Corporate Treasurers
ASIC	Australian Securities and Investments Commission
AR	Accumulation Regimes
BICRA	Banking Industry Country Risk Assessment
BOCRA	Buyer Owned and Controlled Rating Agencies
CBA	Cost Benefit Analysis
CCA	Compliance Cost Assessment
CDO	Collaterized Debt Obligation
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CLO	Collateral Loan Obligations
CRA	Credit Rating Agency
CRARA	Credit Rating Agency Reform Act of 2006
CRD	Capital Requirements Directive
DBRS	Dominion Bond Rating Service
DIDMCA	Depository Institutions Deregulation and Monetary Control Act
EC	European Commission
ECAI	External Credit Assessment Institutions
ECB	European Central Bank
ECOFIN	European Council for Finance
ESMA	European Securities and Markets Authority
ESME	European Securities Markets Expert Group
EU	European Union
FIASI	Fixed Income Analysts Society, Inc.
FSF	Financial Stability Forum
FSB	Financial Services Board
FT	Financial Times

GFMA	Global Financial Markets Association
ICGN	International Corporate Governance Network
IOSCO	International Organization of Securities Commissions
LTCM	Long Term Capital Management
MAD	Market Abuse Directive
MBS	Mortgage-Backed Security
MiFID	Markets in Financial Instruments Directive
MPCP	Market Participants Consultative Panel
MR	Modes of Regulation
NMR	Non-Majoritarian Regulator
NRSRO	Nationally Recognised Statistical Rating Organisations
OFWAT	Office Of Water Services
OFTEL	Office Of Telecommunications
OLS	Ordinary Least Squares
PCAOB	Public Company Accounting Oversight Board
RMBS	Residential Mortgage Backed Security
SEC	Securities and Exchange Commission
SIFMA	Securities Industry and Financial Markets Association
SPV	Special Purpose Vehicle
UN	United Nations
RT	Regulation Theory

Chapter One:

Introduction & background to the study

1.0 Introduction

This chapter offers an introduction to the study and begins by giving an overview of Credit Rating Agencies (CRAs) and their role in the global securities market. Despite CRAs being portrayed as the dealmakers in the global securities market, sanctioning the flow of investment capital (Mulligan, 2009; Nicholls, 2005), it was argued that CRAs traditionally operated in a loosely-regulated environment sparking calls for regulation to address legacy problems in the ratings industry (Sy, 2009). The legacy problems cited included allegations that CRAs lacked accountability and wielded unfettered power (Manns, 2009); that the issuer-pays model was conflicted and potentially compromised ratings quality (Lynch, 2009); that the CRA rating methodologies lacked transparency and thus made it difficult for different stakeholders to judge the quality of credit ratings (Calomiris, 2009; Mollers, 2009; Sy, 2009); that the credit rating industry was dominated by the 3 big CRAs (Moody's, S&P and Fitch), stifling competition and denying rating users a wide choice (Deb, Manning, Murphy, Penalver, & Toth, 2011). It was further argued that despite the above shortcomings, there was over-reliance on credit ratings by regulators raising concerns that such regulatory use of ratings led to misplaced confidence as the underlying ratings were not effectively regulated (Lynch, 2009). These legacy problems fuelled calls for the regulation of CRAs, particularly when they were cited as possible triggers for such crises as the 2007-8 global financial crisis.

While the 2009 European Commission (EC) CRA regulations were initially heralded as a solution to the legacy problems in the rating of securities, they soon came under criticism, with suggestions that the regulatory approach taken by the European Commission (EC) may not have been appropriate in addressing the problems identified as possible causes of the 2007-8 crisis (see for example Papaikonomou, 2010; Utzig, 2010). There were suggestions that the scope and extent of the 2009 EC regulatory framework still needed further investigation (Becker, 2011). Notwithstanding the fact that most of the concerns cited above came from academics, there had not yet been any empirical studies validating the concerns from the perspective of the regulated market participants.

1.1 Rationale of the study

Despite the increased role of credit rating agencies in sanctioning the flow of global securities, lack of regulatory oversight over CRA operations has been fiercely debated in academic, professional and political circles (Lynch, 2009; Manns, 2009; Partnoy, 2001, 2010). Notwithstanding the calls for regulation of CRAs, the introduction of the European Commission CRA regulations triggered yet more contentious debates over the appropriateness of the regulatory reforms, their scope, possible regulatory motives as well as the likely unintended consequences of the new regulations (Calomiris, 2009; Johansson, 2010; Mollers, 2009; Posner, 2010; Sy, 2009; Tichy, 2011; White, 2010a). Consequently, this study sought to investigate whether those practitioners working with credit ratings shared the concerns cited above. The study elicited views of UK-based market participants on the perceived impact of the EC regulations on securities market operations in the UK. The study's focus on UK-based market participants was largely hinged on limited resources and the researcher's time restrictions for undertaking the study. The sections below open the thesis with an overview of the securities market, the role of information intermediaries such as CRAs as well as the CRA regulatory environment. A definition of CRAs is offered to set the scene and pave way for subsequent discussions.

1.1.1 Background to the securities market

Securities play a central role in facilitating the exchange of funds between investors and borrowers. The currency for the exchange and distribution of funds is information (Barker, 1997). According to Jensen and Meckling (1976), the onset of the separation of corporate ownership from control made it difficult for investors to access accurate and up-to-date information on investee companies, creating a market for information intermediaries such as credit rating agencies. CRAs went on to fill this information void, bridging the information asymmetry between investors and borrowers (Tang, 2006). Despite this prominent role, the operation of CRAs was traditionally unregulated (Levine, 2012), sparking calls for tighter regulatory oversight of the credit rating agencies. The calls for regulation became incessant, particularly in the wake of various corporate collapses where poor practices among information watchdogs such as CRAs were said to be a major cause (Partnoy, 2009).

1.1.2 Credit Rating Agencies defined

Credit Rating Agencies act as intermediaries bridging information gaps between issuers / borrowers on one hand and investors / lenders on the other (Fennell & Medvedev, 2012). They offer judgements *(*ratings*)* on the likelihood of default for rated debt instruments or securities issued by corporations or governments. Credit ratings act as indicators of risk, denoting the probability of default of the rated entity. Consequently, ratings are crucial in guiding investment decisions in the global securities market. CRAs act as "the first line of defence for investors" (Davies & Green, 2008, p.68) by offering timely information on rating movements. The importance of CRAs in the global securities market was however questioned by Griffin & Sanvicente (1982) who argued that the informational advantages of CRAs were derived from the coercive quasi-regulatory incentives they offered to issuers, coaxing them to divulge non-public information in the hope of getting favourable ratings which in turn attracted favourable borrowing terms. This view depicted CRAs not as valuable information intermediaries, but as necessary market evils that market participants were compelled to use for both competitive and regulatory reasons (Kerwer, 2005a; 2005b).

1.1.3 The CRA role of issuing and monitoring rating movements

According to Altman (1998); Bannier & Hirsch (2010) CRAs perform two key functions around credit ratings. Firstly, they provide initial credit worthiness opinions (ratings) and secondly, they provide a monitoring role to detect and report on any migration in the initially issued rating. The rating migration is therefore an indication that the rated entity's credit quality has either deteriorated (downgrade) or improved (upgrade). Various scholars have argued that CRAs failed to provide accurate and timely indications of rating changes (Frost, 2007; Lombard, 2008; Pinto, 2006). Consequently, investors who relied on such indications may have suffered loss when rated entities deteriorated below investment grade rating levels. White (2010b) however argued that the slow adjustments to credit ratings was not necessarily a fault of CRAs, but an inherent problem in the '*through-the cycle*' approach taken by CRAs in an attempt to maintain rating stability (see also Altman & Rijken, 2005; Tsoukas, Mizen, & Tsoukalas, 2011). The approach to rating '*through-the-cycle'* and its effect on rating transitions is further discussed in 4.4.2.3.

The determination of a credit rating involves distilling complex information regarding a borrower's credit worthiness into a simple, understandable code or rating based on probabilistic abilities to repay a debt. Each credit rating has implications for the borrower's risk levels and thus attracts different levels of interest on the borrowed capital (Lamandini, 2008). Rated entities therefore prefer the highest ratings, which denote lower risk levels and attract more favourable borrowing terms leading to lower borrowing costs.

The information asymmetry between borrowers and lenders saw an increasing reliance by lenders (investors) on CRAs to bridge the information gap, a feat that Jensen & Meckling (1976) attributed to dispersed ownership and separation of ownership from control. Challenging the argument that CRAs reduced information asymmetry between borrowers and lenders, Partnoy (1999) argued that the continued use of rating agencies by market participants stemmed primarily from regulatory use of ratings which inadvertently endorsed or legitimised the quasi-regulatory role of CRAs in securities markets. The suggestion here was that credit ratings were a necessary evil that issuers involuntarily used as a gateway to access funds. The use of ratings in this context was therefore derived from regulatory reliance on the credit ratings (Prasad, 2009).

1.1.4 Origins of Credit Rating Agencies

Credit Rating Agencies started in the US as a direct consequence of the ballooning railroads businesses in the late 19th century (Rousseau, 2006). The need for additional capital required to fund the expanding networks of railroads soon surpassed the capacity of local banks who initially offered loans to the private rail corporations. The railroad firms started issuing bonds to attract a wider investment base. As most of these new lenders or investors were not local to the railroads businesses, they lacked detailed knowledge of how well these businesses performed (Langohr & Langohr, 2008). Consequently, there was need for the assistance of information intermediaries who could screen such investments and provide some synthesised information on their performance and risk. Credit Rating agencies fulfilled this role by offering initial ratings, subsequently monitoring them and issuing updates on any rating migrations (Alcubilla and Pozo, 2012).

To date, there are more than 150 CRAs in operation around the world although only a few big ones (notably, the big 3; Moody's, S&P and Fitch) operate on a global scale (Harper, 2011). The big 3 tend to offer a broad array of services covering larger geographical areas while the smaller CRAs tend to operate on a niche basis, often in localised areas. At the time of writing this thesis, the big three agencies had a combined market share of over 95% (Alessi & Wolverson, 2012). The dominance by the big three was said to be a barrier to new competition, severely limiting choice in the industry. Table 1 gives a snapshot of ratings issued by top CRAs as at the end of 2011. It is evident from the table that the majority of issuances were concentrated around the big three agencies.

Table 1: Number of ratings per NRSRO as at the end of 2011

NRSRO	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-backed Securities	Government, Municipal & Sovereign	TOTAL RATINGS
AM Best	3	5,364	2,246	54	0	**7,667**
DBRS	16,630	120	5,350	8,430	12,400	**42,930**
EJR	82	45	853	14	13	**1,007**
Fitch	72,311	4,599	12,613	69,515	352,697	**511,735**
JCR	156	31	518	64	53	**822**
LACE	17,263	60	1,000	0	61	**18,384**
Moody's	76,801	5,455	31,008	106,337	862,240	**1,081,841**
R&I	100	30	543	186	123	**982**
Realpoint	0	0	0	8,856	0	**8,856**
S&P	52,500	8,600	41,400	124,600	1,004,500	**1,231,600**
TOTAL	**235,846**	**24,304**	**95,531**	**318,056**	**2,232,087**	**2,905,824**

Source: *Alcubilla and Pozzo (2012, p.8)*

In Table 1, the total distribution of issued ratings is shown as being largely skewed in favour of S&P, Moody's and Fitch, while DBRS and other smaller CRAs trailed far behind. All the big three CRAs had the majority of their ratings in sovereigns, local and national governments where they accounted for over 80% of total ratings for S&P; 69% for Fitch and 80% for Moody's respectively. The next highest focal area according to Table 1 was asset-backed securities, making up 10% of total ratings for both S&P and Moody's. Fitch's second most popular focus was evenly-spread between financial institutions and asset-backed securities all making up 14% of the company's ratings. In the aftermath of the financial crisis of 2007-8, securities ratings were weakened, resulting in a shift of CRA focus towards sovereigns as evidenced by the EU sovereign crisis which made headlines and further cast doubt on CRAs and their ratings (Gärtner, Griesbach, & Jung, 2011).

The role of credit rating agencies as arbiters and gatekeepers of securities information saw them gain a prominent, yet contentious role in global securities markets (Hunt, 2009a). The contentions arose from several tenets of the credit rating agency operating model and will be discussed in more detail in Chapters 2 and 4 of this thesis. While credit ratings were (and continue to be) used not just by market participants, but also by regulators for capital market legislative purposes, (heightened particularly under Basel II)[1] CRAs themselves traditionally operated in an unregulated market, particularly in Europe[2] (Sy, 2009; Utzig, 2010). This was despite their increasingly entrenched role as arbiters of investment information in the securities market. When CRAs were linked to corporate collapses, accused of failing to proactively provide informative ratings to forewarn investors of deteriorating invested stock, their lack of regulation was flagged up as a possible cause of poor standards in the securities market (Levitin, 2009). In particular, it was argued that the lack of regulation left CRAs unaccountable (Manns, 2009); resulted in disparate and opaque rating approaches and could possibly have been a catalyst for further market problems (Elkhoury, 2008).

These concerns led to calls for CRAs to be regulated as a way to usher in stricter standards and ensure that CRAs were accountable in their rating activities. Despite increasing concerns and calls for CRA regulation, there were no active regulatory efforts made in this regard in Europe (Humphreys & Jaffe, 2012). In its 2005 report, the Committee of European Securities Regulators (CESR) concluded that CRA regulation was not necessary to address alleged rating failures associated with the fall of Enron. Instead, CSER recommended continued reliance on the voluntary International Organisation of Securities Commissions (IOSCO) Code (Rousseau, 2009). It was also felt at the time that the activities of CRAs were covered through three EU Directives namely; the Market Abuse Directive (MAD), the Capital Requirements Directive (CRD) as well as the Markets in Financial Instruments Directive (MiFID) and that between these directives, the IOSCO Code (*monitored by*

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[1] *The Basel Committee established standards on international adequacy and further entrenched the role of CRAs in determining minimum capital requirements for depository institutions. Despite the 2004 version coming in to correct seeming loopholes in its 1998 predecessor, the Basel II accord also suffered from criticisms related to its complex nature and the burdens that it imposed, potentially raising borrowing costs and compromising its effectiveness.*

[2] Except *in the USA where the Securities and Exchange Commission, (SEC) established the Nationally Recognised Statistical Rating Organisation, (NRSRO) designation in 1975 as an attempt to enforce standards by regulating the rating agencies.*

CESR) and individual country regulators, there was ample scope for oversight of CRAs across the European market. Calls for regulation thus failed to yield any meaningful results.

1.1.5 The international aspects of credit ratings

Despite the US origins of CRAs, their reach became global as they became the defacto global arbiters controlling the flow of securities. Consequently, attempts to regulate CRAs in the USA were relevant to the rest of the world owing to the global nature of CRA operations. An analysis of CRA operations, their methodologies and market participants' perceptions cannot therefore ignore the US origins of CRAs and how they have evolved to what they are to date. This thesis therefore makes linkages between the US regulatory attempts to curtail the operations of CRAs and how such attempts may have influenced later moves by the European Union and its regulatory arm, the European Commission. Further links are made between attempts to guard against corporate collapses where CRAs were blamed for having played a part. The thesis therefore discusses such regulatory attempts as the Sarbanes Oxley Act, Credit Rating Agency Reform Act (CRARA) of 2006, the Dodd Frank Act, (all from the US) together with other global attempts aimed at regulating CRAs such as the International Organization of Securities Commissions (IOSCO) and Basel. The thesis links the US and global CRA regulatory efforts to the EU attempts such as the Committee of European Securities Regulators (CESR) which were all precursors to the 2009 European Commission Credit Rating Agency regulations which are the subject of this study.

1.1.6 CRAs and regulation

The apparent regulatory void in the operations of CRAs, particularly in the European Union was allegedly linked to possible poor practices and low standards in the industry (Justensen, 2009). This attracted calls for regulatory intervention as it was felt that regulation could address the lack of accountability and foster higher standards (Hunt, 2009a; Lynch, 2009; Papaikonomou, 2010). Such calls were fuelled by a fear that CRAs wielded too much power as arbiters of global securities, sanctioning the flow of funds and were consequently perceived to be 'a law unto themselves' (Partnoy, 2009; White, 2009) as they were not accountable to any regulatory authorities, particularly outside the USA.

In the USA, the Securities and Exchange Commission (SEC) kept vigil over the operations of CRAs through its Nationally Recognised Statistical Rating Organisation (NRSRO) designation. Other markets outside the USA subsequently took the NRSRO status as a hint that because the CRAs operating in their markets had an NRSRO status in the USA, the CRAs were seemingly competent enough to work within foreign jurisdictions as well (Davies & Green, 2008). Despite the calls for regulation of credit rating agencies, no real regulation came into force in the EU until after the 2007-8 financial crisis (Justensen, 2009).

The ability of credit rating agencies to provide timely market information was severely criticised particularly leading up to the 2007-8 crisis (Shipman 2007). Previously, credit rating agencies had been blamed for failure to detect the 1997 Asian financial crisis (Othman, Aziz, & Ibrahim, 2010). Shortly afterwards, they were criticised again for being too slow in providing timely rating adjustments ahead of the corporate collapses of Enron, WorldCom and Parmalat among others (Healy, 2003; Lynch, 2009). These incidents severely dented the reputation of CRAs and raised questions on the reliability and timeliness of credit rating adjustments and CRAs' abilities to act as able watchmen, providing proactive rating information to investors (Paudyn, 2011). Some scholars attributed the alleged CRA failures to a number of perceived shortfalls in the rating industry including; opaque rating methodologies used in the rating of securities (Iyengar, 2012); the conflicted position of CRAs particularly as they were commissioned and paid by the same organisations that they rated (Lynch, 2009); the lack of competition in the ratings market (Deb et al., 2011), as well as the lack of regulatory oversight of rating firms (Lynch, 2009) among other reasons. Because of the alleged lack of competition, CRAs were said to have possibly been complacent, limiting choice among rating agencies and possibly causing a lapse in rating standards. These were seemingly justifiable drivers for regulatory intervention according to the proponents of regulation (Lynch, 2009).

Notwithstanding the above concerns, credit ratings played a key role as they were mandatory requirements for some regulated broker dealers and had increasingly become embedded in key investment decisions even outside regulated areas (Mulligan, 2009; Nicholls, 2005).

Rating users had little choice therefore on whether to continue to use ratings or not as there was an implicit regulatory endorsement of ratings on one hand and a market increasingly relying on ratings on the other. Further, there was no viable alternative proffered to replace credit ratings. Sy (2009) highlighted three key benefits of credit rating agencies for the international financial system; (i) bridging information asymmetry gaps, (ii) mitigating principal-agent problems as well as (iii) acting as the eyes and ears of dispersed investors who were potentially divorced from their stocks. It is therefore not surprising that CRAs continued unabated despite growing concerns about their role in the market.

1.1.7 The conflicted CRA revenue model

The issuer-pays model which saw CRAs being commissioned and paid by the issuers that they rated, combined with the fact that CRAs offered ancillary services to issuers alongside their rating services, allegedly placed them in conflicted positions which could have compromised their independence and objectivity when providing ratings (Bolton, Freixas, & Shapiro, 2012). These inherent issues in the ratings market gained prominence particularly after the 2007-8 crisis and led to more calls for CRAs to be urgently regulated. The Financial Stability Forum (FSF) report of 2008 highlighted several weaknesses in the CRA methodologies and recommended greater transparency in CRA operations. Later in 2008, José Manuel Barroso, the European Commission president tasked Jacques de Larosière to institute detailed investigations into the regulation of CRAs in the EU. The results of the investigation largely echoed those of the FSF but further made recommendations outlined in Section 1.1.8 of this thesis. Calls for CRA regulation largely came from academics (Crotty, 2009; Gupta, Mittal, & Bhalla, 2010; Pettit, Fitt, Orlov, & Kalsekar, 2004; Sy, 2009) primarily to address perceived market deficiencies. The exact nature of regulation being advocated was however not clear and sentiments were often divided on the exact role and extent of such regulation.

Following the 2007-8 global financial crisis, the European Commission (EC) initiated consultations on the regulation of credit rating agencies operating within the European Union. On 16 September 2009, Regulation No. 1060/2009 was gazetted by the European Commission and subsequently took effect from 7 December 2010 (Official Journal of the European Union, 2009).

The new regulations replaced the previous Commission Communication of 2005[3] and sought to; (i) set up an EU-wide oversight system for CRA registration; (ii) enact some requirements on CRA governance; (iii) restrict CRA operational activities to ensure conflicts of interest were managed as well as (iv) set standards for enhanced disclosure and transparency on CRA methodologies and performance.

The 2009 EC regulations however subsequently attracted criticisms from the regulated entities as well as academics and other stakeholders who had previously called for them. There were arguments that the regulatory approach would not work (Staikouras, 2012); that the regulatory scope was too narrow (Utzig, 2010); that the regulatory approach was a kneejerk reaction and not well-thought through (Fisch, 2010), and that the new regulations could have adverse unintended effects on market operations (Avgouleas, 2009; White, 2010a). Following concerns from various stakeholders, the UK House of Commons Treasury Select Committee convened hearings on 29 February and subsequently on 7 March 2012 for various securities market experts to give evidence on the role of credit rating agencies in the 2007-8 financial crisis and reflections on efforts taken to mitigate the impact of the debacle. Further, the committee enquired as to whether the EC regulatory approach was perceived to be an appropriate response in addressing the identified market failures leading to the crisis. From the evidence presented to the committee, witnesses felt that the failure leading to the 2007-8 crisis was systemic and not just confined to credit rating agencies. Several concerns were raised on the current regulatory attempts aimed at credit rating agencies in the EU. The overall reaction towards the EC regulations suggested that there was need for more empirical evidence on the perceived impact of the new EC regulatory approach, which is what this study aims to address. Questions on the effectiveness and appropriateness of the EC regulations were also raised by academic scholars (Staikouras, 2012) suggesting that the regulations were not perceived to be effective.

[3] *Upon the publication of CESR's first compliance report at the end of 2005 stating that CRAs had generally complied with the ISOSCO Code, the European Commission subsequently issued a communicae in 2006 to the effect that regulation of CRAs in Europe was not necessary as there were no grounds for this based on CESR's report (ESME, 2008).*

As CRAs provided ratings used by regulators to enforce minimum capital requirements under BASEL II, CRAs became viewed as quasi regulatory agents or proxies. In particular they were viewed as coercive regulators since such capital requirements were mandatory for depository institutions (Kerwer, 2005b). This emanated from the fact that some ratings users (broker dealers and depository institutions) were compelled to use ratings. Meanwhile, credit ratings were perceived to be hardcoded into major investment decisions (Deb et al., 2011), giving CRAs an entrenched position in this area as well. This sparked many contentious debates about the mandates of CRAs (Rousseau, 2006). Their pervasive impact also raised questions of accountability and how CRAs were traditionally left to their own devices despite controlling the flow of global securities investments amounting to trillions of dollars. CRAs played (and continue to play) a key role for both borrowers and lenders (Kerwer, 2005b) and the impact of regulation on them will likely affect both sides of the relationships (i.e. borrowing and lending). There were concerns therefore that if the EC CRA regulations were misaligned as suggested by the various concerns raised above, the regulations could have adverse effects on the functioning of securities markets, not just in the EU, but globally as well (Darbellay & Partnoy, 2012).

Further, perceived disproportionate regulatory pressures in the EU could lead to regulatory arbitrage and portray the EU as an unattractive securities market (Opp & Opp, 2011) when compared to other loosely-regulated markets outside the EU. In all the above concerns regarding CRAs and their operations, there were no studies presenting market participants' views towards the EC regulations. As market participants work directly with CRAs and would be affected by the EC regulations, an empirical study capturing their views would be important in validating concerns raised by academics and others outside the industry. This study therefore sought to investigate UK-based market participants' perceptions of the impact of the EC regulations on the operations of the UK securities market. It is of significance not only to CRAs, but market participants who work closely with CRAs as well as regulators and policy makers currently pondering over the EU credit rating crisis and possible future courses of action.

1.1.8 Overview of the European Commission Credit Rating Agency regulations

Causes of the 2007-8 global financial crisis were blamed on a number of parties, chief among which were credit rating agencies (Utzig, 2010; White, 2010a). Further blame was levelled against the non-existent EU-wide regulations to provide oversight on CRA operations in the region. In their February 2009 report, the Larosière Expert Group[4] proposed a significant overhaul of regulatory measures in the EU financial system to guard against fissures that could cause and exacerbate market destabilizations.

Consequently, on 16 September 2009, the European Commission gazetted Regulation No.1060/2009 with the aim of fostering among rating agencies, accountability and transparency through enhanced disclosure; protecting investors; enhancing competition among CRAs as well as addressing other legacy issues centred around conflicts of interest within the CRA rating business model. The European Commission took the steps to regulate CRAs in recognition of their crucial role in global securities and banking markets against alleged weaknesses in their operations. Credit ratings were acknowledged to be crucial to securities and financial markets, particularly as investors, issuers, borrowers, as well as sovereign governments relied on credit ratings when making financing and investment decisions (Grunert, Norden, & Weber, 2005). It was felt that there was need to ensure that credit ratings used across the EU demonstrated independence, objectivity and were of good quality, having been produced in environments that demonstrated "principles of integrity, transparency, responsibility and good governance" (The European Parliament & The Council of The European Union, 2009, p.1). As a primary requirement, the EC regulations required all CRAs wishing to issue ratings in any of the EU member states to register with the European Securities and Markets Authority, (ESMA), providing such details as their legal status, internal arrangements for handling conflicts of interest as well as provide details of registered offices. This requirement to register in the EU was a proactive step by regulators to prevent the passporting into the EU of ratings generated in third countries outside the EU (Masera, 2010).

[4] *The Larosière Expert Group was an independent advisory panel on European financial supervision set up by José Manuel Barroso (President of the European Commission) to advise the Commission on ways to strengthen oversight systems for the European Financial sector in an efficient and coordinated way utilising the expertise resident in disparate supervisors in different market states. The Group was chaired by Jacques de Larosière which is where it derived its name. One of its recommendations was a stronger regulatory system for the European financial sector.*

Upon receipt of a CRA application, ESMA would respond within 45 days either granting the CRA permission or rejecting the application for the CRA to work in the EU. If the CRA was successfully registered, it would then be subject to ESMA's on-going surveillance monitoring, particularly focusing on rating methodologies.

The EC regulations were also aimed at eliminating conflicts of interests by engendering organisational and operational independence to ensure that CRAs offered unbiased and independent rating opinions. One of the criticisms against CRAs was that their methodologies of generating ratings were unclear and made it difficult for market participants to judge ratings quality (Partnoy, 2006). To that effect, the new EC CRA regulations required transparent CRA methodologies together with enhanced disclosures by CRAs with guarantees of ratings quality underpinned by performance data which was to be sent periodically to the regulator, ESMA. In the first round of CRA regulations, (CRA1) the primary regulators were the relevant market supervisors such as the FSA in the UK, working alongside the Committee of European Securities Regulators (CESR) who were replaced by ESMA in later regulatory revisions. The regulators were to work in a college-type arrangement with Competent Authorities in each market. The regulations came into force on 7 December 2010 with a clear stipulation that any ratings used for regulatory purposes in the EU had to come from registered CRAs.

Following the downgrading of Greece, Portugal, Spain and Ireland by the top three CRAs in 2010, the European Parliament and the European Council (the policy making body of the EU) tasked the European Commission to look into further measures of providing a more coordinated regulatory oversight on CRAs. This led to the revised CRA regulations, (CRA2) on 2 June 2010, under the auspices of a single European regulator, ESMA with powers to: initiate investigations; carry out requisite inspections as well as impose penalties to any errant CRAs. There were criticisms that, despite the revisions, CRA regulations neither addressed issues such as the conflicts of interest in CRA models nor tackled the opaque CRA methodologies (Calomiris, 2009; Mollers, 2009; Sy, 2009). In response to these concerns, the EU CRA regulations were further revised with strict requirements for additional disclosures; stricter measures to address conflicts of interest; mandatory requirements for analyst rotations; introduction of civil liability among CRAs; competition and market concentration levels among other requirements.

Responses to the regulations and the associated raft of amendments discussed above generated strong reactions in the market. Major concerns cited were that regulations were kneejerk (Sy, 2009; Tichy, 2011); narrow in scope (Papaikonomou, 2010; Utzig, 2010); politically-motivated (Calomiris, 2010); that they would fail to address the legacy problems in the market (Posner, 2010) and that they were likely to have adverse unintended consequences in the market (Lynch, 2009). Most of the reservations about the EC CRA regulations came from academic scholars and were largely theoretical in nature.[5] As most concerns did not have empirical support, this raised the question on whether market participants would share the same sentiments since they would be affected by the regulations. Consequently, this study sought to empirically investigate the validity of these concerns from the viewpoint of market participants working with credit ratings. The study objectives are discussed in section 1.2.

1.2 Research aim and objectives

While there were strong calls for CRAs to be regulated, it would appear that the introduction of the EC regulations in the EU may not have completely addressed concerns around credit ratings. On the contrary, there were further fears that the regulations could have unintended consequences on market operations as regulators may not have fully understood the market context. This was said to emanate from the fact that the regulations were distant from market operations, suggesting a need for the views of those closer to the operations of CRAs. This study elicited the views of UK-based market participants working in or around credit ratings on their perceptions of the impact of the new EC regulations on the operations of the UK securities market. The aim of the study was therefore to:

Investigate the UK-based market participants' perceived impact of the European Commission Credit Rating Agency regulations on the UK securities market / UK ratings market

The study sought to achieve the above aim by eliciting and analysing the perceptions of three key groups of market participants: issuers, institutional investors and other interested parties, (OIPs).

[5] *See for example Opp, Opp and Harris (2012); Rousseau (2009); Partnoy (2009); Maris (2009); Utzig (2010); Darbellay & Partnoy (2012); Buckley & Arner (2012)*

To offer a more balanced perspective, the study also sought the views of representatives from the top credit rating agencies as a way of triangulating the views obtained from the other groups of market participants named above.

1.2.1 Research questions

To achieve the aim stated above, the study sought answers to the following research questions:

a) How do market participants perceive the EC regulations to be addressing legacy problems identified in the UK ratings industry?
b) What do UK market participants perceive to be the impact of the EC regulatory changes on the UK securities market/UK Credit Ratings market?
c) With CRA funding models alleged to be central to problems in the ratings industry, what are the perceived alternative approaches that could equally address the problems identified in the UK ratings market; which ones are most preferred by the UK-based market participants?

1.3 Overview of the Study participants

The study participants were drawn from professionals working in or closely with credit ratings and credit rating agencies. The first group of participants comprised institutional investors who are the primary consumers of credit ratings. The second group was made up of issuers who issue debt instruments and commission as well as pay credit rating agencies. A broad-based third group of Other Interested Parties, (OIPs) pooled together diverse participants with an interest in credit ratings. Lastly, views were also sought from representatives of Credit Rating Agencies themselves as they are the primary target of the EC regulations. At the conclusion of the study, a total of 30 participants had been interviewed. A detailed breakdown of the makeup of the participants will be discussed in Section 5.4 of this thesis.

1.4 Contribution of the study

This study aims to make a number of contributions to theory and practice in the literature on credit rating agencies as well as securities regulation in the EU. Firstly, the study expands literature on credit rating agencies as well as regulation by employing a behavioural perspective to examine the motivations and influences at play between individuals and institutions in the credit ratings market. Previous studies on credit ratings have largely taken economic theoretical perspectives, investigating the technical and functional aspects of credit ratings. In so doing, they potentially downplayed behavioural and sociological factors as well as the role of individual and institutional drivers shaping behaviours and actions in credit rating circles.

The traditional depiction of regulation in extant literature tends to treat regulation as being externally imposed down on regulated entities[6]. This view suggests that regulation is exogenous and treats the regulated entities as passive victims of the regulatory process. Contrary to the exogenous view above, this study places regulated entities at the centre of the regulation formulation process (see for example Ellig (1991); Becker (1983; 1985)). It treats regulated entities as key in internally driving the regulatory process. The view therefore endogenously affirms the crucial role of regulated entities in informing the regulation formulation process as a way to maximise their own payoffs, while minimising regulatory burdens for mutual benefits (Reiter 1996). The role of regulated entities playing a crucial part in regulation formulation is particularly important in specialist areas where regulators may not know as much as those they seek to regulate. This was found to be particularly so in the complex, dynamic and rather closed credit ratings market. This study therefore offers a new perspective of the relationships between the regulator and those regulated using the endogenous theory of regulation as a theoretical lens.

[6] *See for example Baldwin et al (2012); Baldwin & Cave (1999); Ayres & Braithwaite (1992)*

According to Oswick & Grant (1996) and Cornelissen et al. (2008) the use of metaphor in organisational studies is rather limited and the authors encourage more studies in this area. This study responds to that call by employing the use of inductive analysis of metaphors so that the study innovatively captures market participants' portrayal of their perceptions of the impact of the EC regulations, enabling richer insights into regulation issues.

At a theoretical level, the study brings together economic regulation, behavioural and sociological perspectives to better understand the dynamics of the regulation of credit rating agencies in the EU as perceived by UK-based market participants. This approach employed the endogenous regulation theory (Becker 1985; Ellig, 1991) to illuminate the behavioural intents and impact thereof on the relationships between the regulators and their subjects. This therefore extends literature in this area by offering a new theoretical perspective.

At a practical level, the study offers insights into market participants' reactions to the EC regulations post the 2007-8 crisis and seeks to demonstrate how the regulations are seen to work (or not to work) by those working in the industry as well as the perceived impact (both intended and unintended) of the regulations on the surveyed participants. This contributes to an enhanced understanding of the relationships between regulatory initiatives at policy level and the practical understanding of market participants on the ground.

A further practical level contribution of the study emanates from the fact that as the current EC regulations are perceived to be inefficient (see for example Nichols et al. (2011); Papaikonomou (2010); Utzig (2010), this calls for a rethink of enacting additional legislation or revising existing ones. The implication is that regulators and politicians ought to take stock of what has gone well or not gone well with previous and current regulatory initiatives before making any further regulatory attempts. Recent reversals and changes of regulations from CRA1 through to CRA3 suggest that the initial regulatory proposals may not have been thought-through enough and do not inspire confidence among regulated communities particularly with forthcoming regulatory amendments. This therefore informs further regulatory revisions.

1.5 Structure of the thesis

Following this introduction, the next chapter *(*Chapter 2*)* offers a historical account of credit rating agencies, highlighting their importance in the global securities market. Thereafter, Chapter 3 offers a critical review of extant literature in the regulation area, focusing largely on economic regulation theory and using this to identify tenets of good regulation. Chapter 4 reviews extant literature on credit rating agencies, highlighting the focus of previous research studies in the area as well as the literature gaps of interest to this study. Chapter 5 discusses the theoretical and philosophical underpinnings of the study together with the adopted study design. Chapter 6 outlines the data analysis approach adopted in the study, comprising the analysis of metaphor and non-metaphor data. Chapter 7 presents and discusses the findings, making connections with relevant extant literature drawing from various theoretical perspectives to better explain the study findings. The closing chapter (Chapter 8) sums up the thesis and offers conclusions together with reflections on the study contribution to knowledge as well as recommendations for further research.

1.6 Chapter summary

This chapter gave an overview of the thesis, beginning with a brief introduction and background on credit rating agencies, (CRAs). The alleged contribution of CRAs to failures that led to the 2007-8 global financial crisis was presented as the precursor to regulation No.1060/2009 of the European Commission. The EC regulations were aimed at addressing the failings that allegedly triggered the 2007-8 global financial crisis, targeting legacy problems said to be inherent in CRA revenue models. Despite the introduction of the EC regulations, it was highlighted that there were still concerns on whether regulation was the appropriate remedy to address issues identified in the operations of CRAs within the EU. Further, it was highlighted that although the form, scope and scale of the proposed regulation had come under scrutiny by scholars and others interested in the area, there had not been any studies empirically investigating the views of market participants working directly with CRAs. This study therefore investigated the views of UK-based market participants likely to be significantly affected by the new regulations due to their close proximity to credit rating agencies.

A brief overview of the research objectives was presented, together with an outline of the different market participants involved in the study. An outline of the thesis was presented to enable easier navigation through this document. The next chapter offers an overview of credit rating agencies, giving a historical account that chronicles the evolution of the rating agencies from their inception around the late 19th century to the present day.

Chapter Two:

Background on Credit Rating Agencies (CRAs)

2.0 Introduction

This chapter gives a historical background of credit rating agencies, delineating their functions, ownership structures as well as track record, dating back to their inception in the late 19th century. The chapter then traces changes in the CRA revenue models, setting a platform for later discussions that consider the contentious issues allegedly said to be linked to the conflicted issuer-pays CRA revenue model. The section below opens the discussion by revisiting the definition of credit rating agencies and placing their role within a broader global securities market context.

2.1 Overview of Credit Rating Agencies

Credit Rating Agencies, (CRAs) are independent finance market gatekeepers who provide credit worthiness opinions on identified borrower entities (De Haan & Amtenbrink, 2011; Katz, Salinas, & Stephanou, 2009; LaFrance, 2009). Jensen & Meckling (1976) attributed the information asymmetry prevalent in securities markets to the agency issues emanating from separation of ownership from control. Consequently, dispersed investors may not have detailed insights into the companies they want to invest in. This information asymmetry is said to have seen investors increasingly rely on CRAs and other information intermediaries to provide insights on targeted investee companies. This view therefore legitimised CRAs as bridging the information asymmetry through their ratings (Tang, 2006).

Partnoy (1999), however argued that the entrenchment of rating agencies in securities markets was largely correlated to the regulatory use of ratings which coercively legitimised the CRA role of information intermediation. This view was not so straightforward, owing to the paradoxical regulatory reliance on ratings on one hand, (Papaikonomou, 2010; White, 2010a) contrasted with the highly disclaimed nature of ratings as 'mere opinions' on the other (White, 2001).

A parallel can be drawn between Partnoy (1999)'s view above and Spira (2000)'s study of audit committees where the latter questioned their effectiveness as corporate governance mechanisms, concluding that the increased role and popularity of audit committees was better explained by their ceremonial role which acted as a reassurance to resource providers (in this case, investors).

The same can be said of CRAs particularly when viewed as certification agents and gatekeepers, sanctioning the flow of resource information between investors and borrowers (Stover, 1996). Despite increasing questions on their real contribution to investor protection, CRAs legitimise borrowers and at the same time, entrench their own role as arbiters of information between lenders and borrowers (Hill, 2009).

As briefly highlighted in Chapter 1, CRAs historically offered free ratings to issuers, deriving their revenue through the sale of ratings-related publications (Cantor & Packer, 1995). Since the 1970s, the CRA revenue model changed to the current issuer-pays model. This arose as a result of threats to the then investor-pays model owing to increased information sharing through the use of new copying technologies, fuelling a free-rider problem (White, 2010a). In the new model, CRAs were (and still are) commissioned and paid by the issuers (borrowers), who wanted to raise capital. Such issuers wanted as high a rating as possible, so as to attract favourable borrowing terms to avert regulatory pressure and / or reduce the cost of capital (Kuhner, 2001).

Rating agencies on the other hand seek to maximise their earnings by winning rating business from as many issuers as possible and if possible, retain issuers for continued patronage to guarantee future revenue streams (Darcy, 2009). The relationship between issuers and CRAs is thus mutually beneficial, raising questions of potential conflicts of interest, which can undermine the objectivity and independence of CRAs in evaluating the creditworthiness of issuers (Darcy, 2009; Sy, 2009; Hill, 2009). Their ability to provide investors with accurate, objective, independent and timely market information is therefore said to be in potential jeopardy as CRAs have to ensure that they provide good customer service that should see their issuer clients coming back (Lowenstein, 2008; Cinquegrana, 2009; Lynch, 2008). It is argued that such good customer service may have seriously compromised the objectivity of ratings in the past. The allegedly conflicted relationships between CRAs and issuers were identified as being significant contributors to the causes of the 2007-8 global financial crisis (Rotheli, 2010).

Concerns about possible conflicts of interest in the CRA-issuer relationships were further exacerbated by the alleged lack of competition in the CRA market. There were allegations of unfair competition in favour of the big three dominant CRAs (Nazareth, 2003). The current state of the Credit Rating Agency market was said to be a direct product of the Securities and Exchange Commission (SEC), who came up with the NRSRO designation in 1975 (Mainelli, 2008). This came in the wake of the high profile corporate collapses of Penn Central and prompted the US Government, through the Securities and Exchange Act of 1934 to promulgate the designation of the Nationally Recognised Statistical Rating Organisation designation (Rosner, 2009). The move was meant to ensure that commercial papers being traded in the US market were appropriately vetted by reputable rating organisations who were credible enough for regulatory authorities to rely on their ratings (Dittrich, 2007). The SEC therefore exclusively granted the NRSRO status and in the 1970s, only three CRAs had this status (S&P, Moody's and Fitch).

This state of affairs meant that smaller CRAs who wanted to access the industry found it difficult to do so owing to the lack of credibility and market experience which were prerequisites to attain the NRSRO status (Ely, 2009). Through the NRSRO designation, the SEC therefore inadvertently created a barrier to entry that limited competition among CRAs (Jones, 2004). To get NRSRO status, new CRA entrants had to demonstrate extensive market experience, yet on the other hand, in choosing a CRA, issuers tended to favour only those CRAs with the NRSRO designation. This effectively acted as a barrier to entry for new and relatively unknown CRAs, protecting the incumbent top 3 CRAs, (Moody's, S&P and Fitch) who between themselves controlled more than 95% of the market (Dittrich, 2007; LaFrance, 2009).

At the time of writing this thesis, there were 9 NRSROs. There are however more than 150 rating agencies globally who operate without the NRSRO designation, usually in specialised niche areas where their ratings are not used for regulatory purposes (Frost, 2006; White, 2010a). Before delving deeper into the anatomy of credit rating agencies, the section below briefly gives an overview of credit ratings.

2.2 Credit ratings defined

A credit rating is described as a “judgement” (Deb et al., 2011, p11) or opinion (Partnoy, 2001) offered to denote an issuer or borrower’s ability to make full and timely repayments to meet their debt obligations. The Oxford Dictionary of English defines an opinion as “a view or judgment formed about something, not necessarily based on fact or knowledge; an estimation of the quality of worth of someone or something, or a statement of advice by an expert on a professional matter” estimation, evaluation or a formal expert judgment” (Oxford Dictionary of English, 2010, p.1245). The same dictionary further defines a ‘judgment’ as “an opinion or conclusion” (p.947). These definitions are important as they depict a credit rating as an estimate, not an absolute. From the definitions above, ratings are portrayed not as the categorical, objective, absolute calculations that they are sometimes made out to be (Iyengar, 2012). Rather, they are portrayed as having subjective elements that lend themselves open to possible different interpretations because of their subjective (interpretive) construction. This definition of credit ratings has significant implications when discussing the understanding of and use of ratings in global securities markets by market participants and regulators alike.

According to Sinclair, (1994), a credit rating incorporates publicly-available quantitative financial information and qualitative media coverage, issuer-provided internal information describing the position of the company both in competitive and competence terms, together with other externally provided information by interested parties such as competitors, former employees among others. Such information is subjective and so is its interpretation. CRA analysts and issuer personnel deliberate on the above to arrive at indicative ratings and “..accordingly, such judgements are highly subjective” (Sinclair, 1994, p.140). Issuers generally have a right to appeal against a rating if they believe it does not accurately reflect the state of their issue or firm. This further evidences the subjectivity of ratings. It is not uncommon for credit ratings to be revised after appeals by issuers. According to Partnoy (1999; 2001), ratings are devoid of any informational value, owing largely to their lagging nature and predictive inabilities, yet paradoxically, CRAs have entrenched themselves and their ratings at the heart of global capital markets by peddling nothing other than highly disclaimed opinions supposedly taken and used at users’ risk.

The subjective nature of ratings as judgements and opinions was corroborated by the disclaimers from CRAs emphasising that their ratings were mere opinions (White, 2010), that did not constitute a recommendation "to buy, sell or hold a security", (Elkhoury, 2008, p.2). In addition, CRAs asserted that their ratings in no way indicated the long term creditworthiness of the rated stock, but merely offered a snapshot opinion at a point in time (Katz et al., 2009). This raised poignant questions on the value of ratings as guides that investors could use for gauging and predicting default risk, particularly considering the monitoring role of CRAs. Of notable concern was the seeming over-reliance on these ratings by market participants and regulators despite this rather shaky post mortem presented above. According to Deb et al., (2011), credit ratings in the UK and the world over were now 'hardcoded' into investment decisions, major financial arrangements as well as regulatory determinations of net capital reserves.

Table 2 shows examples of investment decisions and other contractual arrangements with ratings 'hardwired' into them. Words like 'hard-wired and hardcoded' connoted some routinized, inflexible programming, rendering human judgements redundant. Hardcoded investment decisions suggest the railroading of investment practitioners into choosing pre-set options. It is easy to see why there could have been blind use of ratings by some investors particularly if they were operating on prescriptive investment guidelines tailored on particular CRAs.

Table 2: Examples of Ratings hardcoded into investment decisions

Purpose	Comment
Investment mandates / policies / criteria for index inclusion	Ratings are often wired into the investment mandates of life insurers, pension funds, mutual funds etc. They also determine eligibility criteria for inclusion in bond indices that track a certain segment of the credit market (e.g. investment-grade bonds; sub-investment grade bonds) and act as performance benchmarks for fund managers.
Access to capital markets	The cost and availability of funding in capital markets is often linked directly to a borrower's credit rating. Indeed, access to some financial markets is restricted to issuers with ratings above a particular threshold. For example, access to wholesale funding markets is typically restricted to entities with a sufficiently high short term credit rating.
Secured funding and repo markets	Similarly, secured funding and repo markets rely heavily on CRA ratings. Gorton and Metrick (2010) observe that pre-crisis, banks' increasing demand for secured funding from the parallel banking system (e.g. money market mutual funds, structured investment vehicles, CDOs) led to a commensurate increase in the demand for high-quality collateral, typically identified by its credit rating.
Collateral agreements and loan contracts	Many financial contracts include references to credit ratings. For instance, the Credit Support Annex (CSA) of a standard International Swaps and Derivatives Association (ISDA) Master Agreement in the OTC derivatives market specifies the terms on which collateral calls will be made. CSAs often state that additional collateral will be called in the event of a credit rating downgrade.

Source: Deb et al, (2011, p6)

Duan & Van Laere (2012) categorised credit ratings into buy-side and sell-side ratings. The buy-side ratings are provided by CRAs at the instigation of investors on an '*as-and-when-necessary*' basis and therefore do not tend to be publicly shared. The sell-side ratings on the other hand are initiated by issuers who commission CRAs to rate specific securities issuances so as to use the resultant ratings when marketing such securities issues. As issuers commissioning the CRA are interested in a positive investment grade rating, this raises questions of possible conflicts of interest where the CRA could be influenced by the issuer to issue unduly favourable ratings (Cantor & Packer, 1995). Much of the debates and concerns on credit rating agencies and credit ratings have previously centred on sell-side ratings. Similarly, this study focused on sell-side rating activities and contentious issues around regulatory proposals introduced in the area.

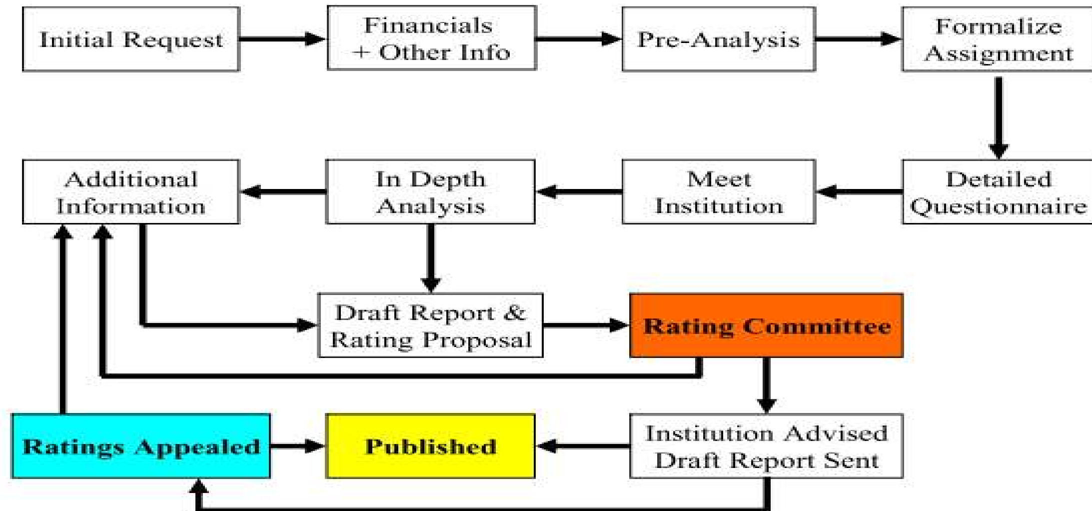
The sell-side rating opinions are aimed at reducing information asymmetry between lenders or investors on one side, and borrowers or issuers on the other side (White, 2001). The assigned credit ratings denote the creditworthiness of borrowing companies or countries (Elkhoury, 2008) denoting their assets, liabilities and payment histories together with projected abilities to meet future debt obligations among other things. While regulators and other participants heavily relied on credit ratings, it was paradoxical to note that the same ratings were highly disclaimed by the institutions that issued them, relegating them to mere 'opinions' (White, 2001).

2.2.1 The ratings process

Typically, rating decisions involve credit rating analysts going through publicly available information from the issuer, covering financial and non-financial information (Sinclair, 1994). More detailed information is obtained in company visits for meetings with the concerned issuing company management personnel to discuss company prospects and management projections. Thereafter, analysts review the financial and non-financial information in light of the management comments and subsequently make recommendations to a ratings committee. The committee considers such recommendations before making final rating decisions. Prior to ratings being published by the CRA, issuers are notified of the provisional rating to allow them to make representations in case there are omissions by CRA analysis (Krahnen & Weber, 2001; Lehmann, 2003).

Issuers therefore have an opportunity to respond and present to the CRA any material information that could change the rating outcome but may not have been considered by the rating agency in making the initial rating recommendation (Frost, 2007). Figure 1 summarises the credit rating process.

Figure 1: The Credit Rating Process



Source: (CI, 2011, p.1)

Credit ratings consider both the quantitative and qualitative attributes of borrowers. The qualitative attributes would include such issues as market prospects, stability, diversity, competitiveness as well as broader external government and regulatory factors which could alter the company's prospects and affect its earnings (Partnoy, 2002). The quantitative or financial attributes include such factors as the balance sheet strength, the borrower's cash generating ability, their gearing as well as interest coverage ratios (Piazolo, 2006). The qualitative and quantitative rating information is distilled into coded ratings in the format shown in Table 3 using the conventions from the respective CRA.

From Table 3, it can be noted that S&P and Fitch use largely similar rating scales, with Moody's using slightly different but related scales. On 26 April 1982, Moody's rating gradations changed from their initial 9-category scheme comprising the letter-based ratings to the current 19 categories with numerical signifiers (Tang, 2006). The change offered Moody's more flexibility to issue broader ratings within each category and allowed for further qualification of different positions within respective categories (Holthausen & Leftwich, 1986; Tang, 2006).

Table 3 summarises the different rating conventions used by the 3 main rating agencies (S&P, Moody's and Fitch).

Table 3: Credit Rating Scales used by the top 3 CRAs

<table>
<tr><th colspan="2">Moody's</th><th colspan="2">S & P</th><th colspan="2">Fitch</th><th></th></tr>
<tr><td>Long term</td><td>Short term</td><td>Long term</td><td>Short term</td><td>Long term</td><td>Short term</td><td></td></tr>
<tr><td>Aaa</td><td rowspan="6">P-1</td><td>AAA</td><td rowspan="4">A-1+</td><td>AAA</td><td rowspan="4">F1+</td><td>Prime</td></tr>
<tr><td>Aa1</td><td>AA+</td><td>AA+</td><td rowspan="3">High grade</td></tr>
<tr><td>Aa2</td><td>AA</td><td>AA</td></tr>
<tr><td>Aa3</td><td>AA-</td><td>AA-</td></tr>
<tr><td>A1</td><td>A+</td><td rowspan="2">A-1</td><td>A+</td><td rowspan="2">F1</td><td rowspan="3">Upper medium grade</td></tr>
<tr><td>A2</td><td>A</td><td>A</td></tr>
<tr><td>A3</td><td rowspan="2">P-2</td><td>A-</td><td rowspan="2">A-2</td><td>A-</td><td rowspan="2">F2</td></tr>
<tr><td>Baa1</td><td>BBB+</td><td>BBB+</td><td rowspan="3">Lower medium grade</td></tr>
<tr><td>Baa2</td><td rowspan="2">P-3</td><td>BBB</td><td rowspan="2">A-3</td><td>BBB</td><td rowspan="2">F3</td></tr>
<tr><td>Baa3</td><td>BBB-</td><td>BBB-</td></tr>
<tr><td>Ba1</td><td rowspan="14">Not prime</td><td>BB+</td><td rowspan="6">B</td><td>BB+</td><td rowspan="6">B</td><td rowspan="3">Non-investment grade speculative</td></tr>
<tr><td>Ba2</td><td>BB</td><td>BB</td></tr>
<tr><td>Ba3</td><td>BB-</td><td>BB-</td></tr>
<tr><td>B1</td><td>B+</td><td>B+</td><td rowspan="3">Highly speculative</td></tr>
<tr><td>B2</td><td>B</td><td>B</td></tr>
<tr><td>B3</td><td>B-</td><td>B-</td></tr>
<tr><td>Caa1</td><td>CCC+</td><td rowspan="5">C</td><td rowspan="5">CCC</td><td rowspan="5">C</td><td>Substantial risks</td></tr>
<tr><td>Caa2</td><td>CCC</td><td>Extremely speculative</td></tr>
<tr><td>Caa3</td><td>CCC-</td><td rowspan="3">In default with little prospects for recovery</td></tr>
<tr><td rowspan="2">Ca</td><td>CC</td></tr>
<tr><td>C</td></tr>
<tr><td>C</td><td rowspan="3">D</td><td rowspan="3">/</td><td>DDD</td><td rowspan="3">/</td><td rowspan="3">In default</td></tr>
<tr><td>/</td><td>DD</td></tr>
<tr><td>/</td><td>D</td></tr>
</table>

Source: *Adapted from the 3 CRAs' websites*

CRAs' positions as gatekeepers in the global securities market are well entrenched and have been growing over time (Mulligan, 2009). By 2005 Moody's and S&P had each issued active credit rating opinions on approximately US$30 trillion worth of securities, (Sinclair, 1994). In other words, US$30 trillion worth of investments were dependent on whether Moody's and S&P maintained their ratings, downgraded or upgraded them. A downgrade, especially if it crossed from investment grade to speculative grade would have significant interest rate implications for the borrower. It was therefore in the issuer's interests that their rated entities remained above the investment grade tier and many authors questioned the extent to which issuers could go in protecting this position, particularly if they had leverage over the CRAs providing such ratings (Bai, 2010).

Despite being arbiters of such significant values of global securities, CRAs' internal governance structures were and continue to be questioned (Sinclair, 1994). Further, the limited number of CRAs controlling global securities suggested lack of competition and a stranglehold on the market by the incumbent top 3 CRAs. This could potentially cause complacency and possible adverse effects on ratings quality in the market. The entrenchment of CRAs in US financial securities and later, in the global securities markets can be traced back to the Federal Code of Regulations (*cited in White, 2010*) which stipulated that "insured stage savings associations and others may not acquire or retain debt that is not of investment grade" (White, 2010, p.2). Further, the BASEL II capital adequacy requirement bolstered the role of CRAs by making further requirements that could only be certified by CRAs with a NRSRO designation (Claessens, 2003). The bulk of issues discussed by various scholars in connection with the contentions arising out of the above are covered under the section on previous research on CRAs. The next section revisits the definition of ratings.

2.2.2 Regulatory use of credit ratings

According to West (1973), the US Banking Act of 1936 was perhaps the first regulatory endorsement of credit ratings with the US Comptroller's office prohibiting all national banks from investing in speculative bonds. Later, various regulatory requirements entrenched CRAs and their ratings into the global financial system. Whereas Hunt (2008) asserted the regulatory use of credit ratings to determine minimum capital requirements for depository institutions as well as for the BASEL II accord, Partnoy (2001) termed this "the paradox of ratings" and found it difficult to justify the heavy reliance on credit ratings particularly as ratings came with such significant disclaimers warning users not to rely on them for investment purposes. White (2010, p.2) further gave an example of a typical disclaimer that was found at the bottom of S&P ratings:

> *" …any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision."*

Such a disclaimer was, and is not uncommon with the other credit rating agencies. This further adds weight to the ideas advanced below suggesting that credit ratings are not scientific, objective calculations and therefore should be used with care.

Credit ratings therefore appear to be interpretive constructions that are contextual and should be used diligently to complement other detailed decision-making approaches. If that thought holds true, the value of credit ratings in the flow of securities is slightly weakened, threatening the core business model for credit rating agencies. The use of credit ratings for regulatory purposes may have inadvertently endorsed CRA ratings to investors who blindly and unquestioningly relied on them for investment decisions, (Rousseau, 2009). In a way, the troubled state of CRA affairs could be connoted as a self-made problem attributable directly to both the SEC and Basel II. The irony here was that while there was such emphasis on the use of ratings for regulatory purposes, there had been little oversight on the governance of CRAs or how their ratings were generated (Partnoy, 2001). This placed at risk, the resultant regulatory decisions that seemed to be so heavily hinged on such ratings.

The role of credit ratings discussed above has significant systemic ramifications for global securities markets. Whatever happens in credit ratings could have direct consequences on investments, financial contracts and regulatory decisions that are linked to credit ratings. It is therefore a paradox that investors and regulators embedded ratings into their decision-making processes despite the fluid nature of ratings methodologies and credit ratings as discussed above (White, 2001). What is in question here is the use of ostensibly judgmental opinions as if they were 'the' true, objective and unquestionable reflection of reality**.** The nature of ratings and their origin suggests that they should be treated as guidelines not "the guideline" hence the calls for tighter regulation to reduce this over-reliance (FSB, 2010).

2.2.3 Over-reliance on credit ratings

While credit ratings were (and still are) crucial indicators that aid investors in making decisions, it is alleged that for some unsophisticated investors, there was perhaps too much reliance on ratings at the expense of other means of due diligence, (Cantor & Packer, 1995; Coffee, 2008). The alleged blind use of ratings by some investors as if they were concrete guarantees and accurate reflections of market conditions flies in the face of both the regulatory endorsement of ratings and the dismissive attitude of CRAs as portrayed in their disclaimers (Tichy, 2011).

The reliance on ratings for regulatory purposes, when CRAs advise not to rely on them raises significant questions that suggest misplaced confidence in both the investing community and regulators alike. In an earlier critique of the credit rating system, Partnoy (2001) questioned the paradoxical increasing reliance by regulators on credit ratings as these were generated in an opaque way that was not overseen by any regulatory authorities, thus posing a danger for the regulators and the markets. A second paradox was the increasing reliance on ratings while the information quality of such ratings was perceived to be declining over time (Papaikonomou, 2010). Against this background, many issuers found themselves compelled to seek ratings and gain favourable reputations despite being allegedly free not to do so (Kerwer, 2005a; 2005b). The regulatory endorsement of credit ratings portrayed CRAs as coercive quasi-regulators, perceived to be playing the role of regulatory agents (Kerwer, 2005a; 2005b).

The above line of thought questions the governance arrangements of the regulators, the robustness of their assumptions, decision-making frameworks and the soundness of their decisions on the regulated entities. The sections below consider the nature of credit ratings and further question the ostensible treatment of ratings as guaranteed objective calculations of credit worthiness, when in reality these were subjective interpretations that were so readily dismissed even by the very institutions that generated them (White, 2010b).

The dilemma that some investors faced and perhaps continue to face is understandable if one takes the subtle regulatory endorsements of ratings to be the official signpost of their importance in securities markets (Partnoy, 2001). From that perspective, investors who relied on ratings may have derived some sense of reassurance from the fact that regulators would not endorse credit ratings if they were fallible. This may have promoted a herding culture of blind group behaviour which was alleged to be one of the underlying causes of the 2007-8 global financial crisis, (Deb et al., 2011). This will be explored in more detail in the ensuing sections. Having defined credit rating agencies and their ratings, section 2.3 gives a historical account of credit rating agencies and their credit ratings.

2.3 Historical account of credit ratings

The history of rating agencies can be traced as far back as 1841 when Louis Tappan founded the first rating agency to rate merchants following the financial crisis of 1837 in the US (Cantor & Packer, 1995). About two decades later, Henry Varnum Poor published the "*Manual of the Railroads of the United States*" (Wolfson & Crawford, 2010; Setty & Dodd, 2003). Later, around 1909, Moody's came to the scene with the publication of "*Analyses of Railroad Investments*". By 1922, Moody's had expanded their analyses to include industrials and public utility ratings (West, 1973). Poor's and Moody's were the dominant forces in the early twentieth century until they started encountering competition from the Standard Statistics Company between 1922 and 1941. The Standards Statistics Company subsequently merged with Poor's to form Standards and Poor's, (S&P) (West, 1973). It was not until the 1970S that credit ratings began to be officially recognised and endorsed by the US government. This recognition came in the form of the 1975 Securities and Exchange Commission (SEC)'s Nationally Recognized Statistical Ratings Organizations (NRSRO) rule 15c3-1.

Despite issuing ratings that were used for regulatory and other purposes, CRAs were traditionally protected by the First Amendment in the USA. This treated their ratings as opinions equivalent to those of any other private citizens recognised and protected under the freedom of speech in the USA (Nagy, Epstein, Martin, Magliocca, & Zinsmaster, 2009). Despite the commercial nature of their rating opinions, under the First Amendment protection, CRAs hid behind journalistic privileges, protecting them from any litigious actions that could potentially arise out of possible inaccurate ratings. Consequently, ratings came with heavy disclaimers that absolved CRAs of any blame whatsoever should users of such ratings suffer any negative consequences following their use (Partnoy, 2001).

The reliance on credit ratings had received a major boost when bank regulators mandated US banks to invest only in bonds that were deemed safe. Safe bonds in this case were those with ratings of BBB or better using the S&P rating scale (*refer to Table 3 for details on rating scales*). The safety measure was an investment grade rating (White, 2008) as opposed to risky, speculative ratings. At the time, the recognised rating agencies were S&P, Moody's and Fitch.

2.3.1 Expanded role of credit ratings into regulatory areas

In subsequent years, the role of credit ratings extended to cover the determination of minimum capital requirements for insurance companies as well as stipulations on the minimum safety levels for bonds that insurance companies could invest in (Cantor & Packer, 1995). A similar move was adopted by regulators of the US federal pension schemes in the 1970s. These moves effectively cemented the regulatory role of credit ratings in the oversight of securities markets in the US. This entrenchment of CRAs as quasi-regulatory agents was despite the fact that CRAs themselves operated in a loose regulatory environment with only the SEC providing tokenistic oversight in the USA and no oversight in the EU or other parts of the world (Partnoy, 2006). This drew criticisms and calls for regulation, particularly with the 1970s move from the user-pays model to the issuer-pays model (Strobl & Xia, 2012). The fact that under the issuer-pays model, rating agencies were commissioned and paid by the issuers presented potential conflicts of interest. The incentives for issuers to get high ratings and the need for CRAs to maximise their revenues and earnings from issuers were said to have the potential to compromise CRA independence, allegedly weakening the objectivity of the issued ratings.

The fact that CRAs were not seen to be accountable to anyone raised further fears around their unfettered power in the market (Freeman, 2007; Pinto, 2006). The ratings model incorporating private, profit-seeking businesses (CRAs) offering ratings to issuers, whose interests lay in getting the highest possible rating so as to minimise borrowing costs raised possible conflicts in the relationships of the two entities (Strier, 2008). This fear was further compounded by the fact that CRAs offered ancillary advisory services such as consultancy services which could have seen them rate the same entities they would have helped put together, particularly in structured securities. Despite incessant criticisms of this approach over the years, the issuer-pays model survived to the present day (Kuhner, 2001).

Various scholars over time advocated the regulation of credit rating agencies as a way of addressing some of the concerns raised above (Crotty, 2009; Gupta, Mittal, & Bhalla, 2010; Pettit, Fitt, Orlov, & Kalsekar, 2004).

Despite these calls for regulation, evidence suggests that previous regulatory efforts in the ratings market were seemingly triggered by, and reacted to various crises and were never proactively planned (Helleiner & Pagliari, 2009). The following sections briefly discuss the alleged role of credit rating agencies in previous corporate collapses and financial crises.

2.4 The alleged role of CRAs in financial crises and corporate collapses

Credit rating agencies were identified as culpable in a series of high profile corporate collapses spanning a number of decades (Utzig, 2010). This sparked calls for CRAs to be tightly regulated to prevent possible future crises (Pettit et al., 2004). As an example, the collapse of Enron back in 2001, and the role of rating agencies in the debacle, attracted significant scrutiny and further fuelled calls for regulation of credit rating agencies (Hill, 2002). The Enron debacle in particular was centred on the failure by CRAs to respond in a timely manner by adjusting the company's rating ahead of the collapse. Table 4 gives a snapshot timeline view of Enron's rating leading to its collapse in 2001.

Table 4: Enron's rating leading up to its collapse

Date of Change To	Category	Outlook
03 December 2001	D	....
30 November 2001	CC	Watch Negative
28 November 2001	B-	Watch Development
09 November 2001	BBB-	Watch Negative
01 November 2001	BBB	Watch Negative
25 October 2001	BBB+	Negative
02 June 1997	BBB+	Stable

Source: Piazolo, (2006, p.8)

As shown in Table 4, Enron was highly rated until shortly before its collapse, raising questions on CRAs' abilities to accurately track ratings and forewarn investors in a proactive manner. Enron's rating adjustment on 28 November appeared to be market-led as opposed to being proactive. Criticisms on rating agencies following this collapse were largely centred on the role, competence and effectiveness of credit rating agencies (Hill, 2004). Later, the subsequent 2007-8 financial crisis further exacerbated calls for regulation of rating agencies with views that the global financial crisis was partly attributable to failures in the rating agencies themselves (Howard & Green, 2008).

With the rating agency regulations now in place in the EU, one would have thought that the issue of regulating credit rating agencies had finally been put to rest. On the contrary, new concerns arose suggesting that the regulations were not finely-tuned enough to address the problems that had led to the crisis in the first place (Staikouras, 2012). This raises questions on what form of regulation would be deemed appropriate for the market, a subject that the next chapter attempts to conceptualise by reviewing regulation literature in search of relevant frameworks. The section below briefly traces the regulatory arrangements around credit rating agencies.

2.5 Regulation of Credit Rating Agencies

Since the inception of the NRSRO designation by the SEC in 1975, several guises of regulatory attempts to regulate credit rating agencies were made, largely in response to various crises. Arguably, one of the defining tenets of the modern financial architecture is its propensity to collapse. Dymski (2003) highlighted nine major economic crises that acted as precursors to the current global financial architecture. A closer analysis of Dymski (2003)'s line of thought posits financial crises as inherent and inevitable features of the modern financial architecture and cannot be wished away even by regulation. Nonetheless, debates about improving the financial model of the global financial system continue to unfold and regulation seems to be a key tool proposed to achieve this. Table 5 summarises Dymski (2003)'s highlights of the most recent economic collapses.

Following several high profile corporate failures, there was a compelling need for regulators, (particularly US regulators) to devise a more reliable mechanism of ensuring investor protection and fostering market stability. The introduction of the Nationally Recognised Statistical Rating Organisation (NRSRO) designation by the SEC in 1975 came in to address growing concerns around the oversight of CRAs. The NRSRO role became embedded into rule 15c3-1 in 1975 as an attempt by the SEC to regulate broker-dealers and ensure that they held adequate capital reserves to act as a fall-back measure in case of liquidity problems. This move also served to distinguish between CRAs that could be relied upon to produce ratings for regulatory purposes (Wolfson & Crawford, 2010). Rule 15c3-1 positioned ratings as official regulatory measures of determining compliance with broker-dealers' minimum capital requirements.

Table 5: List of economic collapses and crises in recent years

Date	Crisis	Perceived triggers
1994-95	Mexican Tequila crisis	A sudden downward spiral of the Mexican Peso
1997-98	The Asian Financial crisis	Had its origins in Thailand following the floating of the Thai baht aimed at shoring up dwindling foreign currency reserves
1998-99	Russian Rubble credit crisis	Fixed exchange rate against declining productivity and a high fiscal deficit
1998-99	Run on the Brazilian Real	Allegedly triggered by Russia's default which in turn raised concerns on low foreign currency reserves and consequently, Brazil's ability to meet its external debt obligations.
2000	The Turkish crisis	Escalating exchange rate risks and lack of support of the Turkish programs by the IMF.
2001-02	The Argentinean economic crisis	Decline in the country's GDP allegedly originating from the country's military dictatorships
2002	Brazilian real attack	Triggered by political concerns over Brazil's possible defaults on its debt obligations
2002	Uruguayan collapse	Caused by a considerably shrinking economy which was largely dependent on Argentina and thus susceptible to Argentina's own crisis in 2001-2
2007-8	Global economic collapse arising from the US subprime mortgages	Greed and conflicted interests among market players; Poor regulatory oversight / regulatory inertia; incompetence

Adapted from (Dymski, 2003; Eatwell & Taylor, 2000)

From Table 5 above, the frequency of corporate collapses and crises suggests that perhaps these are an inherent feature of the modern financial construct. Rather than be managed away, regulation may only reduce their impact and frequency. It is hoped that each successive financial crisis provides useful lessons that if taken onboard, can help reduce the intensity, duration and frequency of future crises. Section 2.5.1 gives a detailed overview of the US NRSRO designation.

2.5.1 The Nationally Recognised Statistical Rating Organisation, (NRSRO)

The 1970 Penn Central collapse[7] triggered calls for more systematic and credible rating of commercial papers as a way of reassuring investors of the papers' commercial viability. Following the collapse, the SEC introduced the NRSRO designation under the Securities Exchange Act of 1934, a move aimed at regulating the rating of commercial papers issued by regulated entities. The SEC allowed broker-dealers to hold lower capital reserves provided they had a high rating from a NRSRO (Fennell & Medvedev, 2012).

[7] *Penn Central collapsed in June 1970 after its formation two years earlier from a merger between Pennsylvania Railroad and the New York Central Railroad Company. At the time, the collapse was said to be the largest in US history, leaving creditors and stockholders penniless. Because of the central role of railroads at the time, the failure, which was attributed to mismanagement, had a devastating impact on the economy.*

Control of the US Credit Rating Agency market lay in the conferment of the NRSRO status which was the preserve of the SEC. Upon receipt of the applicant CRA's NRSRO application, SEC officials would research the CRA's market experience, reliability and credibility. If they were satisfied that such a CRA could be relied upon to issue ratings to be used for regulatory purposes, the SEC would then issue a "no action letter" (Coskun, 2008, p.265). This was a seal of approval from the SEC guaranteeing that if the applicant CRA's issued ratings were used for regulatory purposes by a regulated broker-dealer, the SEC would not take any action (legal enforcement) towards the rated entity. The NRSRO designation therefore gave CRAs some quasi-regulatory powers, acting as watchdogs responsible for determining net capital reserves for regulated entities (Sinclair, 1994). This role led to the coercive use of ratings by broker-dealers who wanted to meet regulatory requirements. Other than the application vetting process and the conferment of the NRSRO designation, there was little else that the SEC seemingly did in practice to regulate credit rating agencies and monitor their performance on an on-going basis (Wolfson & Crawford, 2010). There was no clear definition of the NRSRO designation and the conferment criteria remained hazy and lacked transparency (Manns, 2009).

Despite their new quasi-regulatory role, CRA methodologies and general operations remained unregulated. The endorsement of NRSROs and their quasi-regulatory role signalled to the market that regulators were comfortable with the oversight of such NRSROs. In reality, once admitted to the NRSRO club, CRAs were left to their own devices and even the SEC did not have any idea of what was involved in their operational activities and ratings quality levels (Fisch, 2009). The NRSRO status required rating agencies to be vetted by the SEC, ostensibly meeting stringent but undefined criteria. This became a barrier to entry, limiting new and smaller CRAs from attaining the NRSRO designation. Only three rating agencies attained the NRSRO status between 1975 and 2003, (S&P, Moody's and Fitch), effectively restricting the choice available to issuers. The three leading NRSROs dominated the market and collectively commanded up to 98% of the global ratings market between them (Wolfson & Crawford, 2010).

Despite attempts to enhance competition, to date, there are only 9 NRSROs (from the previous ten, after the withdrawal and de-registration of Ratings and Investment (R&I), the Japanese rating firm). The global total number of rating agencies is said to be between 50 (Dittrich, 2007; LaFrance, 2009) and above 150 CRAs operating outside of the NRSRO designation, usually in specialised niche areas (Frost, 2007).

From the above discussion, it is not inconceivable to conclude that the lack of competition among CRAs arose from the SEC's NRSRO stranglehold of the market, particularly in the USA. Although the NRSRO designation was a SEC invention in the US, as there was no equivalent standard in Europe or indeed anywhere else in the world, hence other markets defaulted to the same standard. The acceptance of the NRSRO status in other jurisdictions outside the USA further legitimised and entrenched incumbent CRAs in the global securities market. Therefore, the NRSRO designation gave markets a false sense of comfort in the role of CRAs as quasi-regulatory agents. Some blame for the current ills of the ratings industry can therefore be apportioned to the SEC as the architect and guarantor of the NRSRO system. This is because only CRAs with the NRSRO status could generate ratings used for regulatory purposes, (Dittrich, 2007). At the same time, regulatory reliance on ratings signified to the market (somewhat coercively) a need to get rated or use a rating from a NRSRO, thus further endorsing NRSROs.

1975 marked a turning point for the rating agencies who had previously earned their keep by selling ratings to users under the 'investor-pays' model (Mullard, 2012). Becker, (2011) attributed the move away from the investor-pays model to the proliferation of technologies that made information exchange easier, making it difficult for ratings to be copyrighted. This allegedly made ratings widely available even to those investors who had not paid for them, thus compromising the earning potential of the respective CRAs. These developments turned ratings into public goods and rendered the investor-pays model unattractive. Thereafter, CRAs switched to the current issuer-pays model which was said to be 'deeply conflicted' (Lynch, 2009) and a possible cause of the ratings debacle that led to the 2007-8 financial crisis.

Following the corporate collapses of Enron and others, the Credit Rating Agency Reform Act (CRARA) of 2006 was passed by Congress in the USA. The act required the SEC to set up a formal CRA registration process with clear guidelines on the transition into a NRSRO. After the CRARA in 2006, the number of NRSROs went up to ten, including such new players as A.M. Best, Egan Jones, DBRS, Japan Credit Rating Agency, Ltd, Kroll Bond Rating Agency, Inc., Rating & Investment Information, Inc. as well as Realpoint LLC. Despite the increased number of CRAs following the CRARA of 2006, the three dominant CRAs, (S&P, Moody's and Fitch) still held over 94% share of the global ratings market by 2008 (Hunt, 2008; Fennell & Medvedev, 2012). In choosing a CRA, issuers tended to favour only those CRAs with the NRSRO designation. Further, reputation and market history seemed to favour incumbent CRAs as users did not want to risk their issuances with new untried rating players. This catch-22 situation effectively acted as a barrier to entry for new and relatively unknown CRAs, inadvertently protecting incumbent CRAs, particularly the top three, (Moody's, S&P and Fitch) (Dittrich, 2007; LaFrance, 2009). Other regulatory attempts were made in the credit ratings market including the International Organization of Securities Commissions (IOSCO) Code, which is discussed in 2.5.2 below.

2.5.2 The International Organisation of Securities and Exchange Organisations (IOSCO)

IOSCO was formed in 1983 to be the standards body with oversight of the securities market worldwide. It evolved from the inter-American regional association which came into being in 1974 but with a remit limited only to North and South America. After its inception, there was not much activity from IOSCO. In 1998, the IOSCO principles were published and adopted. The principles comprised a set of objectives and standards for securities regulation aimed at improving auditor independence, disclosure and transparency, identification as well as management of conflicts of interest. It was not until a number of high profile corporate failures such as Enron and WorldCom in the early 2000s that IOSCO started visibly pushing for standards for CRAs. The corporate failures saw IOSCO later adopting a memorandum of understanding that sought more coordinated international cooperation and free, timely exchange of information on securities matters globally (IOSCO Technical Committee, 2004). Thereafter, IOSCO published the Code of Conduct Fundamentals for Credit Rating Agencies in 2004.

The Code of Conduct stipulated guidelines for the quality and integrity of securities ratings, together with the monitoring of ratings, CRA independence, as well as recommendations regarding robust internal procedures aimed at addressing CRA conflicts of interest. The code also emphasised the need for timely rating adjustments, transparency as well as disclosure by CRAs on the extent to which they complied with the code (IOSCO Technical Committee, 2004).

Despite the IOSCO code being a positive cross-border move to provide oversight on securities ratings, the initiative suffered from a number of key weaknesses. Firstly, the IOSCO code was voluntary and carried no legal force to enforce compliance (Brummer, 2010). Secondly, the guidelines were so general as to leave the specifics of the ratings process open to CRA interpretation (Cinquegrana, 2009). These and other loopholes severely weakened the IOSCO code and rendered it ineffective in addressing the concerns raised about credit rating agencies (Maris, 2009). The intention behind the IOSCO code was for CRAs to adopt and embed principles of the IOSCO guidelines into their own internal policies and then work towards demonstrating their compliance thereto. Where CRAs did not comply with the code, they were to explain clearly why they had not done so as well as outline what measures they had taken to ensure compliance. The expectation was that consistent non-compliance would be picked up by the market which would respond appropriately, otherwise there were no enforceable sanctions by IOSCO (Cinquegrana, 2009). This approach leaned towards the reputational capital theory which will be discussed in section 4.1.2 of this thesis. Cognisant of the weaknesses of the IOSCO code, the US government enacted the Credit Rating Agency Reform Act, (CRARA) in 2006. This is discussed below.

2.5.3 The Credit Rating Agency Reform Act (CRARA) of 2006

Following various corporate collapses in the United States, there was a perception that the lack of regulatory oversight on credit ratings among other things posed a significant threat to the viability of securities markets, not just in the USA, but globally. This was due to the central role that credit ratings were deemed to play in the "financial reputation of rated companies" (Seitzinger, 2006, p.3). The concern was that despite the heavy reliance on ratings for regulatory and other purposes, there was lack of transparency on the CRA rating methodologies.

It was not clear how CRAs were internally governed to safeguard against such issues as conflicts of interest. Attempts to rally behind the IOSCO code had left the market exposed as the code was voluntary and not legally enforceable. The Credit Rating Agency Reform Act of 2006 was therefore promulgated to restore market confidence through fostering improved quality of ratings and enhanced transparency and disclosure (Sy, 2009). The Act also sought to protect investors as well as encourage more competition among rating agencies and consequently, eliminate complacency in what was viewed as a cosy oligopolistic credit rating market. Despite its noble intentions, the CRARA did not prevent the 2007-8 global financial crisis. Consequently, following the 2007-8 global financial crisis, the US government introduced the Dodd-Frank Act primarily to identify and address threats to the US' financial stability (Johnson, 2011). The Dodd-Frank Act will be discussed in more detail after a brief overview of the Basel accord, which came into force much earlier than the Dodd-Frank Act.

2.5.4 The Basel II Accord

The Basel II accord came into force in 2004 under the auspices of the Basel Committee on Banking Supervision, (a committee set up in 1974 comprising central bank governors from the Group of ten[8] aimed at establishing sound global banking supervision practices). The Basel II accord was brought in to offer a clearer measurement of risk in a more systematic and transparent way (Saidenberg & Schuermann, 2003). The Basel Committee established standards on international adequacy, which further entrenched the role of CRAs in determining minimum capital requirements for depository institutions. This in a way indirectly endorsed the role of CRAs and may have induced relaxation on due diligence (Partnoy, 2006). Despite the 2004 version coming in to correct seeming loopholes in its 1998 predecessor, the Basel II accord was said to be equally burdensome and rather complex, potentially raising borrowing costs. The argument that CRAs were quasi-regulatory agents was to a large part based on the Basel II capital adequacy requirements that further entrenched the role of CRAs as watchdogs for compliance levels by depository institutions and other financial companies (Kerwer, 2005b).

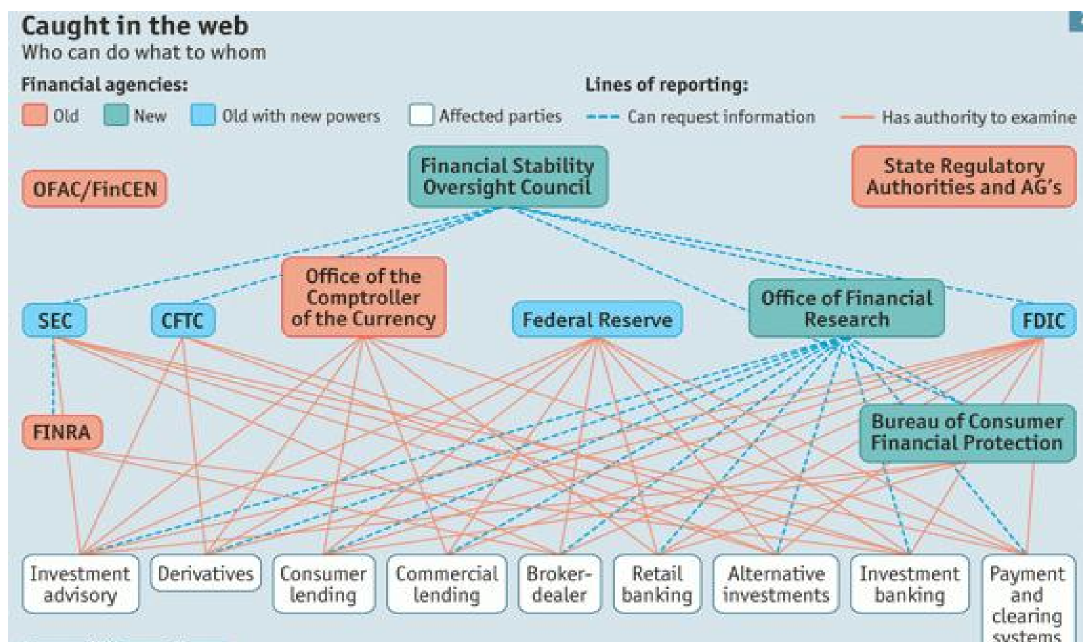
[8] *The Group of Ten comprised members from Belgium, Canada, France, Germany, Netherlands, Japan, Italy, UK, US, Sweden and Switzerland. The G10 countries signed an accord to be part of the General Arrangements to Borrow (GAB) back in 1962 and subsequently went on to set up and fund the IMF as a lender to participating member states.*

2.5.5 The Dodd Frank Act

The early 21st century financial crises in the USA cast a lasting impact on the financial landscape globally. In an attempt to stem further escalation of the 2007-8 financial crisis, the Obama administration signed into law the Dodd-Frank Act on 21 July 2010. The Act gave regulators powers to monitor and manage capital market risks. Primarily, the Dodd-Frank Act sought to foster a new era of accountability through enhanced disclosure and transparency. Specifically, the Act made a direct call for regulatory oversight of CRAs with the SEC mandated to fully acquaint itself with the workings of this industry (Walker, 2010). Regulators were keen to ensure that there were adequate controls to prevent possible bail-outs that characterised the aftermath of the 2007-8 corporate failures. The Act therefore sought to promote sound corporate governance practices and restore market stability in the US financial sector. Like some of its predecessors, the Dodd-Frank Act faced criticisms that it was bureaucratic, complex (the Act was over 1000 pages long); that it was costly and created a complex web of reporting requirements which were potentially burdensome to businesses (Grinshteyn, 2009).

Some of these criticisms questioned the regulatory approach and scope of the Act and will be discussed further in Chapters 3 and 4 of this thesis. As an example, Figure 2 below depicts some of the complexities inherent in the Dodd-Frank Act.

Figure 2: The Complex Web of the Dodd-Frank Act



Source: *Dodd-Frank Summary (2012)*

To stem further collapses and curb the escalation of the 2007-8 financial crisis, the US government paid out in excess of US$29.5 trillion (Felkerson, 2011), while the UK government funded its failing banks to the tune of over £1.162 trillion (Guardian, 2011). The criticism levelled against credit rating agencies as always was that they were too slow to act and were reactive rather than proactive (Coffee, 2010). The section below discusses the regulatory attempts to curb the 2007-8 financial crisis by the European Commission.

2.5.6 The European Commission Credit Rating Agency Regulations

As discussed in 1.1.6, in the aftermath of the 2007-8 global financial crisis, CESR published its second compliance report on 2 July 2008. CESR's report was followed by two consultations from the EC, the first seeking responses from interested parties on the proposed regulatory oversight of CRAs in the EU. CESR's second report sought views on the perceived over-reliance on credit ratings in the EU. On 12 November 2008, the European Parliament and the European Commission formally adopted a proposal to regulate CRAs operating in the EU. Consequently this led to the gazetting of EC regulation No. 1060/2009 on 16 September 2009. Section 2.5.6.1 discusses some of the implications of the EC credit rating agency regulations.

2.5.6.1 Overview of the EC CRA Regulation implications

While the adoption of the EC regulations was the first binding regulatory initiative of its kind in the EU aimed at credit rating agencies, there were insinuations that the original regulatory agenda may have later been hijacked by other political interests (Manaigo-vekil, 2011; Posner, 2010). The regulations were said to be an inappropriate vehicle to address the problems identified in the rating industry (Nichols et al., 2011; Utzig, 2010; White, 2010a). Further, it was alleged that the regulations appeared to take an indiscriminate blanket approach which was reactive and could not prevent further possible crises (Becker, 2011). While there was a widely-held view that CRAs had played a significant role in the causes of the 2007-8 financial crisis as well as previous crises (Coffee, 2010), there did not seem to be a consensus on how the identified problems could be resolved. Further, as the regulation of CRAs in the EU was a new phenomenon, it was perhaps still too early to determine whether the regulatory approach taken would work effectively or not.

Meanwhile, insights can be drawn from other parallel fields such as audit regulation. The section below discusses some of the parallel insights that can help shed light on regulatory initiatives around areas similar to those of credit rating agencies.

2.6 Parallels with audit literature

CRAs and auditors have a shared history, based on the development of the global capital markets with the need for increased investor protection enhanced by the provision of independent opinions on the worth or risk of investee companies (Neuman, 2010). As in the situation with CRAs, the US Securities and Exchange Act of 1933 mandatorily required firms to get independent audits from independent accountants (Watts & Zimmerman, 1983). This fuelled the demand for audit services and led to a proliferation of audit firms. Both CRAs and audit firms operate on a profit basis and are selected and paid by the same organisations they rate or audit, raising concerns of possible bias (Partnoy, 2010; Strier, 2008). The role that CRAs and auditors play versus the exact value they are perceived to deliver through their financial mediation has been subject to debate, leading to what scholars term the audit expectation gap (Humphrey, 1997; Koh & Woo, 1998; Okafor & Otalor, 2013). The role of detecting errors and fraud in both the rating process and audit has been subject to interpretation, making it difficult to apply an objective approach to both auditing and rating practices (Humphrey, Moizer, & Turley, 1993). In a similar notion to the audit expectation gap, section 4.2.3 discusses the contested nature and role of CRAs, arguing that the way CRAs see themselves and their role is different from what their stakeholders perceive and expect. This fundamental difference of interpretation possibly lies at the heart of the diverging views on CRAs and their role. This thesis argues that like audit opinions, ratings are themselves subjective (White, 2001, 2010b), giving rise to a rating expectation gap.

Until such a gap is narrowed through more calibrated definitions of ratings and the role of CRAs, it will be difficult to reconcile the conception and appreciation of CRAs and their role. The subjective nature of ratings and associated implications is discussed in more detail in Section 4.2.3. Like CRAs, despite their questionable role and legitimacy, auditors and audits became mainstreamed into corporate life. To this end, Power (1996, p.1) raised a pertinent question "how can a practice whose benefits are being privately questioned as never before nevertheless come to

occupy such an important role in public policy?" This question could well be asked of CRAs and their credit ratings. The answer lies largely with the regulatory endorsement of the two professions and regulatory use of both ratings and audits in what Shore & Wright (2000) termed '*coercive accountability*.' This coercive use of ratings and audits led to the conception of credit rating agencies and auditors as 'quasi regulatory agents as they were perceived to be playing a regulatory role (Dewing & Russell, 2012; Partnoy, 2006). This is further discussed in 4.3.2.

As with CRAs, auditors suffered from allegations of conflicts of interest, particularly as they also offered ancillary non audit advisory services which were perceived to potentially compromise the independence of their audit services (Campbell & Houghton, 2005). The consolidation of the industry led to the dominance of the big five audit firms[9], forming an oligopolistic situation not dissimilar to that of CRAs (Moizer & S. Turley, 1989). So like rating agencies, audit firms suffered from criticisms on the lack of competition in the industry (Humphrey, Kausar, Loft, & Woods, 2011; Numan & Willekens, 2012). This was said to have possibly led to complacency and lower quality audit opinions (Neuman, 2010). High profile corporate collapses of companies such as Enron led to calls for the audit industry to be tightly regulated, as there were claims that auditors (like CRAs) lacked independence and objectivity; that their audit opinions (like ratings) were inaccurate and possibly over optimistic (Healy & Palepu, 2003) and that there was need for increased competition among audit firms. Audit methodologies, like ratings methodologies were said to be unclear and difficult to pin down. Humphrey & Moizer (1990) used the metaphor of 'black box' when referring to audit methodologies, suggesting that they were difficult to understand.

Across the divide, rating methodologies were similarly questioned and said to be opaque (Elkhoury, 2008). Various remedies were proffered in both ratings and audit fields. Among the proposed solutions were increased competition (Pearson & Trompeter, 1994) and mandatory rotation (for publicly-listed companies in audit) (Arrunada & Paz-Ares, 1997). Mandatory rotation in particular featured significantly in both industries and received mixed reactions from the market.

[9] *The big five accounting firms comprised Arthur Anderson, Deloitte and Touche, Ernst & Young, KPMG and Price Waterhouse Coopers*

In a study on audit rotation Daniels & Booker (2011) found a positive correlation between auditor rotation and perceived auditor independence. While this could be welcomed as a possible remedy for both the ratings and audit markets, it raises pertinent questions about the possible impact on the need for increased competition in both industries. Mandatory rotation could either focus on the rotation of key personnel involved in doing the audits or ratings or alternatively, after defined terms, audited / rated companies would have to seek new auditors or rating agencies. Either way, rotation would impose additional costs to the industry (Bates, Waldrup, Jaeger, & Shea, 2012). Arguably, mandatory rotation could in theory open up opportunities for new entrants. In practice however, new entrants could still struggle to make inroads into a market that uses reputation and track record as a key determinant on the choice of which Audit Company or rating agency to use. If the regulatory objective of attracting more players into both industries was to work, it is difficult to envisage how smaller new players without a lot of resources could afford to rotate analysts or auditors to meet regulatory requirements.

Beyond Enron, the 2007-8 global financial crisis saw criticisms against CRAs and auditors in almost similar measures (see for example DeMaria, 2012; Partnoy, 2010). Their role as intermediaries placed them in similar positions. Since the audit industry has been slightly ahead in attracting regulation, insights from that practice can help shed more light on the regulation of CRAs and possible future regulation prospects. Following Enron's collapse, the Sarbanes Oxley Act of 2002 was brought in to strengthen independence of accounting firms thereby enhancing the quality of audit opinions. The Sarbanes Oxley Act brought about changes in reporting and corporate governance arrangements for audit firms (Beattie, 2012). These moves set the audit firms along the regulatory path much earlier than their credit rating counterparts. It is however arguable whether the quality of audit opinions has improved significantly as a result of the regulatory measures.

Commenting on the regulatory initiatives proposed to improve corporate governance practices after the collapses of Enron, WorldCom and other high profile corporations, Romano, (2005) argued that some of the regulatory initiatives such as banning ancillary non-audit services by auditors in a bid to reduce conflicts of interest were not justifiable.

This argument was grounded on the fact that previous empirical studies seeking to test the relationship between provision of additional services by auditors and audit quality had not found a convincing causal link. In drawing parallels between auditors and rating agencies, questions emerge on whether similar findings may be possible across the two professions, considering the similar roles that auditors and rating agencies play. Further, Romano, (2005) argued that a lot of the regulatory initiatives in SOX were rooted not in the corporate failures highlighted above, but had political and entrepreneurial motivations, outside the regularly-cited corporate failures. This view was consistent with Khademian, (1992) who acknowledged the power of electorates in forcing politicians to formulate regulatory initiatives as a way of appeasing growing discontent from their respective constituents.

Looking at credit rating agencies, questions may be raised on whether the EC regulatory initiatives were solely motivated by the often-quoted 2007-8 global crisis or whether there were other hidden drivers elsewhere. Drawing parallels again with the audit practice, it was noted that the regulatory requirement 'for all listed companies to be audited' (Beattie, 2012, p.3) created an inelastic demand for audit services, inadvertently endorsing the role of auditors within regulatory fields. This requirement equated to the 1975 Rule 15c3-1 requiring broker-dealers to get ratings from NRSROs (Wolfson & Crawford, 2010). So just like in the audit profession, despite their weakening reputations, CRAs' roles remained pervasive, hence their conception as coercive quasi-regulatory agents.

Regulatory efforts in audit have seen twists and turns. The wave of deregulation in the 1980's brought about an influx of business risk audit approaches which were said to have commoditised audit (Giroux & Cassell, 2011; W. R. Kinney, 2005). This spell was cut short by corporate collapses that were later partly blamed on audit, prompting a drive for re-regulation. The Sarbanes Oxley Act of 2002, (SOX) in the USA was a reaction to such corporate collapses as the Enron, WorldCom and Parmalat among other companies. Alongside this, other parts of the world developed similar regulatory initiatives (Kinney, 2005). Following regulatory changes in the USA, the audit industry was impacted particularly relating to: the review of the provision of audit, restricting non-audit services to clients; involvement of the Public Company Accounting Oversight Board (PCAOB) in

providing independent inspection of listed company audits; independent setting of auditing standards; together with a mandate for more closer cooperation between the internal audit committee and auditors (Beattie, 2012; Lennox, 2009). The verdict on whether regulations in the audit profession achieved what they set out to achieve remains open. On a competitive level, the industry still remains dominated by a few big players with smaller ones operating in limited jurisdictions but largely in niche areas. Conflict of interest allegations have died down, probably until the next corporate scandal. Regulatory pressures tend to come in cycles, triggered by each corporate collapse where auditors are involved. The biggest question perhaps is whether all the previously cited issues in the audit industry can be regulated away or whether each crisis or corporate collapse will be unique with lessons to be learned from each successive cycle of regulatory issues. The outcome of the regulatory changes in the audit literature suggests that there is a maturity stage where things quieten down but that allegations may resurface in the event of another corporate collapse or scandal. Perhaps the rating industry will be no different. It remains to be seen whether the current frenzied efforts will eventually die down, only to resurface after the next crisis.

2.7 Credit Rating Agencies post the 2007-8 financial crises

Despite the enactment of the EC credit rating agency regulations, there has not been much observable change among credit rating agency operations. Notable changes have been around the implementation of measures to separate analysis from commercial teams to address conflict of interest issues. In terms of competition, there has been no change, prompting some scholars to argue that the current EC regulations cannot deliver a competitive rating market and that more competition may in fact fuel ratings inflation as CRAs scramble for business (Becker, 2011).

The conflicts of interest around the issuer-pays model still persist. Proposed possible alternatives appear to be equally conflicted. The regulatory reliance on credit ratings has not subsided, despite indications that this needed to be addressed. Overall, it would appear that on paper, the EC regulations have not yet made much difference on the ground in terms of addressing some of the major legacy issues in the ratings market.

After the enactment of the EC regulations, concerns were raised arguing that the EC regulations may not be an adequate response to address the legacy problems identified in the industry (Nichols et al., 2011; Papaikonomou, 2010; Utzig, 2010). While these concerns are noteworthy, they came from scholars and others outside the industry. It was deemed important to gauge whether those practitioners and other market participants working with credit ratings shared these concerns. It was on this basis that this study sought to find out from market participants who work with rating agencies, what their perceptions were with regards to the impact of the EC credit rating agency regulations.

2.8 Chapter summary

This chapter chronicled the evolution of credit rating agencies from their inception in the late 19th century to date, highlighting changes, particularly in the CRA revenue model, examining motivations and possible impact of the changes. The historical account of credit rating agencies was shown as punctuated by various corporate collapses and financial crises triggering a wave of regulatory interventions in the USA. Evidence evaluated suggested that despite regulation being brought in to strengthen economic systems, different initiatives did not seem to have successfully prevented crises in the past. In all the regulatory initiatives chronicled in this chapter, financial regulators seemed to have been on the back foot, reacting to impending crises. Parallels between auditors and CRAs allowed for comparisons to be made across the two fields with inferences drawn to help inform the CRA regulatory process, which arguably lags behind its audit counterpart.

There seems to have been waves depicting upsurges in regulatory pressures which eventually quieten down with time, only to resurface in response to the next corporate failure, raising questions on whether crises can be regulated away and whether the latest EC regulatory initiatives will bring any meaningful and lasting respite to the market; whether the EC CRA regulations were an appropriate response to the 2007-8 crisis; what the possible impact of the regulations will be as well as whether the regulations will be effective in addressing the issues identified in the ratings market. The next chapter explores regulation literature in an attempt to find out whether this study can be situated within broader economic regulation realms and if so, to set parameters for guiding this study and focusing it on appropriate frameworks.

Chapter Three:

Literature Review – *Regulation*

3.0 Introduction

Following on from the previous chapter giving a historical and evolutionary account of credit rating agencies, the conclusion was that despite several financial regulatory initiatives over the years, subsequent crises triggered questions on whether such regulatory attempts were appropriate, timely or focused enough and whether crises can be prevented through regulatory means. This chapter reviews extant economic regulation literature, giving an overview of previous studies in the area to explore the nature and rationale for state intervention. Different strands of economic regulation and requisite theoretical conceptions are discussed, including public interest theory, regulatory capture and the theory of just regulation. The Baldwin & Cave (1999) taxonomy is reviewed to determine its suitability as a framework for judging the effectiveness of the EC regulatory proposals. Merits and demerits of regulatory intervention are critically examined with the intention to apply them to this study in later chapters. On the degree of state intervention, the Ayres & Braithwaite (1992) pyramidal approach is used as a visual framework to pick out the varying levels of state intervention, ranging from persuasion through to licence revocation. Self-regulation is presented as an alternative to state regulation, together with use of voluntary codes, whose alleged failure is said to trigger state intervention. A typology of the different regulatory players considered different orientations and expected behaviours to offer a critique of their possible motives and efficacy.

3.1 Context and background

As the motive of capitalism is to generate or increase wealth, wealth accumulation sits at the hub of economic regulation theory (Boyer, 2000). The accumulation regime encompasses social and economic processes of production and consumption together with the integration of the different classes into coherent systems of production and consumption systems, efficiently directing the flow of goods from production to consumption in the classical economic realm of supply and demand. Unfortunately the capitalist motive of wealth accumulation results in different classes of people depending on who owns the means of production. Ownership of the means of production (other than just labour) brings with it, power and influence and ultimately, inequalities which can cause disharmony.

The danger is that those with resources (and power) may abuse those without, triggering disequilibrium which may be corrected through regulatory intervention. Wealth accumulation therefore has to be kept in check through modes of regulation, otherwise those with power may usurp resources from those without, externalising costs, meanwhile internalising benefits as they continue to amass wealth. Modes of regulation explain the institutional systems and structures that shape people's behaviours both culturally and professionally to align these to the accumulation regime as a way of promoting some semblance of economic and social order. The broader institutions responsible for regulating or shaping people's behaviours include such structures as the church, political parties, trade unions and any other social structures. Inadvertently, some of these institutions organise and shape people's behaviours within, and in line with the wealth accumulation regimes that they exist in.

There is an intricate linkage between the wealth / capital accumulation regimes and the mode of regulation although the relationship cannot be said to be exactly causal (Hirsch, 1995). Despite the interdependence of global capitalist systems, regulation or oversight of the global financial system has largely been fragmented, leaving possible loopholes that offer fertile grounds for fissures and possible crises. Following this logic, the 2007-2008 global financial crisis could be seen as an example of a failure cutting across industries in different national jurisdictions. To correct the crisis, there were proposals that an internationally-coordinated regulatory approach could have been better placed to restore and reinforce the global capitalist hegemony (Zaman, 2009).

The interconnected design of the global capitalist system is such that market failures in one area may have far-reaching ramifications in other areas as evidenced by the 2007-8 global financial crisis. The EC CRA regulatory response however took a Euro-centric regional focus. This raises questions on whether the EC regulations could have been more global to facilitate coordination across different jurisdictions. This point is important owing to the risk of contagion embedded in inter-jurisdiction linkages (Longstaff, 2010). For regulations to be effective, they need the global reach to allow for a coordinated approach to tackle regulatory issues at source.

The EC regional regulatory approach could therefore leave potential gaps which could be sources of future crises due to the global nature of the securities market and business interrelationships generally. On the other hand, a Eurocentric regional approach realistically offers an opportunity to speedily respond to the crisis without international bureaucratic delays. The approach further exploits similarities and synergies of a relatively self-contained region bound by common interests as manifested through the objectives of the EU as a collective.

One of the aims of the EC regulations was purportedly to encourage more players to enter the ratings market and diffuse the current oligopolistic stranglehold of the big three rating agencies (Moody's, S&P and Fitch). While this may be a noble objective, Regulation Theory suggests that fixed costs must be low for competition to set in, i.e. barriers to entry must be low to facilitate new entrants who may not have big resource capabilities. A quick analysis of the CRA market, particularly the perceived potentially high compliance costs brought about by the new EC CRA regulations indicates that the opposite may result. This view is corroborated by a DBRS (2010) response to the EC consultation on the regulations, which highlighted the difficulties that the regulations could impose on smaller rating agencies and potential new entrants. It is thus questionable whether the EC CRA regulations will effectively address legacy problems around competition in the rating market, given the prohibitive compliance burdens embedded in the new EC regulations. The practicality of delivering increased competition, increased investor protection and enhanced ratings quality is therefore questionable (Bondarouk, 2010; Papaikonomou, 2010).

The intricately interconnected global economy suggests that the rationale for regulation be examined from a broader global context as opposed to focusing just on the EU. Whereas the traditional perspectives of a global world order may have seen the world parcelled out into neat categories and packages dominated by the hegemonic capitalist systems of the USA, Hirsch (1995) argues that the traditional powers of the past have ceased to exist as we knew them. A new world order is said to have set in. The new global order is characterised by blurred lines, shifting relationships and interactions which are in a state of constant flux, having to be constantly renegotiated.

The consequence of the new world order is that economic systems have to be continually reshaped to respond to new and emergent challenges and constructs. The shifting global power bases have seen the interchange of ideas where dominant rules-based systems previously gave way to self-regulation and voluntary codes. Whereas scholars previously sold the idea of self-regulation (Bartle & Vass, 2005), evidence suggests that this may not have worked as well as it ought to have and now regulators are having to step in and curb escalation of corporate collapses arising from alleged regulatory and governance failures. A case in point is the 2007-8 global financial crisis that saw regulators stepping up the pressure for active regulatory oversight where previously, self-regulation was preferred *(see for example the voluntary IOSCO 2004 code in the global securities market)*. Regulatory intervention however triggered fresh questions on whether regulation was the appropriate response (Hunt, 2009a); what the impact would be and how far regulation can go before its benefits begin to diminish. To make an attempt to explore these questions further, section 3.2 below begins by defining regulation in its different guises, relating regulation to the focus of this study.

3.2 Regulation defined

Regulation is a multi-dimensional concept whose understanding requires an examination of its impact from a number of broad perspectives including economic, political and even social spheres (Baldwin et al., 2012). Elsewhere, Selznick (1985), in (Baldwin & Cave, 1999, p.42) defined regulation as "*sustained and focused control exercised by a public agency over activities that are valued by a community*." Regulation can be carried out by state agencies, voluntary organisations, private entities, corporations or self-regulators among others (Baldwin et al., 2012). The term, 'regulation' is sometimes used in various guises to encompass formulating rules, supervising the enforcement of those rules and / or monitoring outcomes. Llewellyn (1999) made a distinction between the above three and treated regulation as the rules or codes governing conduct. He delineated monitoring as keeping an eye on compliance to the set codes of conduct. Supervision was less clearly defined but was treated loosely as ensuring that set codes of conduct are complied with, together with the implementation of corrective measures where necessary. Regulation is presented as a process with stages to enforce adherence to stipulated standards, ostensibly to correct some disequilibria in a system.

The stages are all integral to the overall success and effectiveness of the regulatory process. By implication, well-crafted rules on their own may not deliver successful outcomes if poorly implemented. Similarly, lack of monitoring or oversight to gauge the level of compliance and note any deviations and impact thereof may render the regulatory process ineffective. Regulatory actions are designed to deliver set objectives. Such objectives should be clearly spelt out at the onset of the regulatory process as a way to guide the form, extent, scope of regulation as well as the identification of players best placed to drive the process. As regulation is a broad area, this study focuses solely on economic regulation. This is discussed in more detail in section 3.3 below.

3.3 The economic regulation theory

Economic regulation theory concerns itself with two systems; (i) accumulation regime systems (AR) and (ii) modes of regulation systems (MR). The first relates to the evolving nature of economic systems of wealth creation, ownership of the means of production and allocation of resources. The later supports the wealth accumulation systems, by ensuring that there is an optimum enabling environment for maximum wealth creation enhanced through requisite norms, rules and regulations. Following on from the above, if the behaviours of individuals or systems are such that there is disequilibria in the accumulation regime, modes of regulation have to usher in a new order to restore stability.

3.4 Different strands of economic regulation

Since its inception, Economic Regulation Theory has seen different postulations all attempting to better capture the hegemonic shift of regulatory powers as well as the changing role of the regulatory state in a capitalist world. The different conceptions of regulation are best examined through the different theoretical perspectives used to investigate the subject. Some of the key theoretical perspectives in regulation include Pigou (1938)'s public interest theory of regulation; the Stigler (1971) regulatory capture theory, as well as the contracting theory (usually attributed to Coase (1960)). Besides these main ones, there are other theoretical conceptions that have emerged, such as the Just Theory of Regulation, (Lee, 1980) among others. Selected key theoretical perspectives within the realm of economic regulation are discussed in the ensuing sections.

3.4.1 The public interest view of regulation

The essence of this strand of regulation theory is the intervention by government seeking to promote public interests, ostensibly against powerful, wealth-amassing private entities seeking to usurp public benefits for their private purposes. Various controlling mechanisms are used by the state to align private business interests to those of the public. While this strand of regulation seeks to promote public interests, questions tend to centre on whether regulators' motives are primarily driven by a desire to protect the public or their own self-maximising agendas (Peltzman, 1976).

A case in point is when politicians use regulation for political mileage, amassing votes by appearing to be addressing issues of public concern meanwhile doing a tokenistic job, leaving real issues untouched. This sceptical view of the regulatory role of governments and other public regulators purporting to promote public interests was propounded by Stigler (1971) who argued that politicians, like other human beings seek to maximise their self-interests and sometimes such interests may seem to override the promotion of public interests. Stigler (1971)'s view resonated with later views by Peltzman (1976) and Becker (1985) who both recognised the tendency of private interest groups to exert pressure on the regulatory system in ways that generated and privatised benefits for themselves. This was tantamount to regulatory capture. The argument here is that regulation can be used as a vote-seeking proxy by politicians or those in public office who either want to enhance their political prowess or use regulation as a tool to sway voter allegiance.

Government regulatory interventions tend to be scrutinised for hidden political agendas and the EC regulations which are the subject of this study are no exception. Questions were previously raised on how genuine the regulatory aims of protecting investors and the public were (Shleifer, 2005). Similarly, this study raised questions on whether the objectives set for the EC regulatory interventions were consistent with the regulatory approach and whether the motives were aligned to the stated objectives. Economic Regulation Theory is hinged on how a capitalist system can continue to sustain itself despite its conflicted nature emanating from class, wealth and other inherent disparities embedded in its construct.

The constant tugs posed by the divides between members of society due to such factors as class, wealth levels and diverging political interests among others, threaten the very foundations of the capitalist system (Neilson & Rossiter, 2008). Faced with similar divisions, any system would probably implode. The capitalist system seems to have endured and has successfully sustained and reinvented itself in the face of the challenges named above. Part of the capitalist system's ability to reinvent and sustain itself has perhaps emanated from the discerning role of respective governments who have stepped in to quell any public disquiet when disequilibria set in. In rebalancing the interests of the few vs. those of many, regulators need to be careful not to overburden the tax payers through cumbersome, bureaucratic and costly regulations. Regulation theory therefore seeks to "explain who will receive the benefits or burdens of regulation, what form regulation will take, and the effects of regulation upon the allocation of resources" (Stigler, 1971, p.3).

The relevance of the above to this study on EC CRA regulations stems from the fact that for a long time, there were incessant calls for external regulation to rebalance the dynamics of the securities markets where CRAs were seen to be wielding unfettered power but without any form of regulatory oversight or accountability on their own operations (Partnoy, 2001). Other concerns centred on the overreliance on ratings by regulators (Coffee, 2009); the unclear role of CRAs as both market players (gatekeepers) and contracted regulatory agents whose rating opinions drove regulatory decisions and thus influenced markets (Verschoor, 2007). All these concerns yielded no external regulatory intervention in the EU until after the 2007-8 global financial crisis. From a regulation theory viewpoint, the previous external regulatory inertia by those responsible could be explained by the strong CRAs who may have wielded enough influence to convince regulators that they were capable of self-regulating through voluntary codes, thus keeping external regulation at bay (Peltzman, 1976). At the same time, the incumbent CRAs managed to raise entry barriers, restricting new competition in the industry. The inability of regulators to assert themselves in the period prior to the 2007-8 crisis could arguably be attributed to regulatory capture which is discussed in the ensuing section.

3.4.2 The capture theory of regulation

In the capitalist system discussed in 3.4.1 above, private actors prefer to be left alone to manage their affairs without the perceived burden of regulatory oversight. Where possible, such actors may seek to usurp regulatory processes to suit their private pursuits, actively lobbying and influencing regulators to seek outcomes that favour their private interests as opposed to public interests (Olson, 1965). In response to such lobbying pressure, lawmakers may be swayed and coin regulations that are aligned to the powerful private actors. Consequently, government regulators across different jurisdictions may themselves compete to appear more lenient to the cause of these private actors in a bid to competitively attract interest returns (Tollison, 1988). Where central governments provide the regulatory oversight, increased centralisation may ensue, with the central government growing phenomenally as measured by budgets and size of the public service. Pursuit of revenue maximisation may see the social objectives take a slightly secondary position (Brennan & Buchanan, 1980) as regulators are captured by those they seek to regulate. Diversion of regulatory benefits for private gain is a central feature of the capture theory of regulation.

The capture theory of regulation posits a possibility of social losses arising from the expropriation of regulatory benefits as the regulator becomes naturalised into the environment of the regulated entities (Stigler, 1971). The exact nature of regulatory capture may see the regulator becoming too involved with, or too dependent on the regulated entities to the extent that the regulator eventually 'sees regulatory issues from the perspective of the regulated entities' (Thompson, 2003, p.22) and begins to sympathise with the regulated subjects to the extent of possibly lowering regulatory standards or turning a blind eye to some issues that would otherwise attract regulatory penalties. Consequently, regulators in such circumstances fail to fulfil their mandate of stabilising or correcting markets for public benefit.

According to Stigler (1971), wealth-maximising interest groups such as industrial organisations can deliberately capture their regulators if the accruing benefits of such capture exceed benefits to the outside public. This suggests deliberate acts by industrial or other regulated interest groups to usurp the power of politicians (who direct regulatory efforts) for private gain.

The implication is that benefits are internalised by the captors, possibly leading to society paying for any resultant externalities. Regulators then become conflicted as they serve the interests of their captors or their own at the expense of the rest of society where they may draw their electoral mandate from (Kalt & Zupan, 1984).

Notwithstanding the above, Peltzman (1976) argued that in reality, the potential loss to politicians and regulators resulting from being captured greatly outweighed any potential benefits. His argument was that based on that logic, it was inconceivable that regulators could willingly risk their reputations for what he perceived to be little short term incentives. These views pose topical questions on whether the regulatory vacuum in the ratings market leading up to the 2007-8 crisis was an act of omission or commission by the regulators and politicians alike. The former would connote incompetence on the part of the regulators, while the later could suggest possible complicity by the regulators leading to their capture by the CRAs or other as yet unclear players.

The act of regulatory capture in modern day capitalist economies is perhaps not too distant from possibilities of sleaze and self-aggrandizement that manifest themselves in the corporate world right under the oversight of the regulators. If indeed regulatory capture occurred in the regulation of CRAs, it would be key to find out who the beneficiaries of any such capture were; how the capture affected and / or continues to affect the market as well as the nature of benefits that accrued to the captors. One of the weaknesses of the capture theory of regulation is that it views regulations as exogenous, i.e. externally imposed on regulatory victims. The voice of the regulated seems to be silent in the regulation formulation process. This was opposed by Becker (1983; 1985) who argued in favour of an endogenous theory of regulation. The endogenous view posited regulation as co-determined, with the regulated entities actively engaging in shaping the regulatory process. The implication then was that regulators and their regulated entities were partners in a way, co-creating a regulatory environment that offered mutual benefits. Endogenous regulation is explored in more detail in section 3.4.3 below.

3.4.3 The endogenous theory of regulation

Ellig (1991) concurred with Becker (1983; 1985) arguing that the regulatory process is not a straightforward top-down process where the regulators force down regulations onto a passive community. On the contrary, they posited a framework where the regulated community actively and proactively engaged the regulators to co-determine the resultant regulations. They argued that this led to a socially-constituted regulatory outcome shaped as much by the interests of those regulated as by the regulators (Malloy, 2010). The downsides of this argument may manifest themselves in politically-sensitive situations where regulators wanting to win campaigns, may yield to unrelenting pressure from powerful private interest groups, at the detriment of the public. Nevertheless, this theoretical framework attempts to capture some power and interest issues at play in regulatory environments. This theoretical conception provides a useful backdrop against which to evaluate the EC regulations, particularly noting the absence of the voice of regulated entities in seminal literature such as Baldwin et al., (2012); Baldwin, (2008)

3.4.4 Just regulation

Lee (1980) offered a critique of economic regulation theory, asserting that different forms of regulation resulted in winners and losers, a scenario that conjured unattractive connotations in modern day economies emphasizing fairness and justice. As an example, by suppressing producer or supplier practices, there was an implicit benefit transfer to consumers through lower prices which could derive from increased competition and increased drivers for efficiency which in turn could lead to lower production costs. This however does not equitably serve the interests of all concerned (Lee, 1980), suggesting that the process had winners and losers, polarising the concerned parties. Consequently, the author proffered an alternative regulatory conceptual framework, addressing three requirements as follows:

(i) Making both the regulated and their consumers better off,
(ii) Equalising the playing field so that there was no benefit or cash transfer between the regulated and their consumers and,
(iii) Fairness of the regulator in adjudicating over prices.

The last point suggests an impartial and objective approach to regulation which is not only non-partisan, but is utilitarian in nature, attempting maximum benefits to all concerned. Applying this logic to the EC CRA regulations, it can be noted that some of the intentions of the regulations were aimed at increasing CRA competition, restoring market confidence through protection of investors (consumers of ratings), as well as offering a consistent regulatory approach across the EU. The first element of a just regulatory approach from Lee (1980) above would fall away as by their nature, the EC regulations are curtailing what was perceived to be runaway practices of CRAs. The regulation therefore takes away some freedoms from CRAs, questioning the fairness and justice in the EC regulations when viewed using Lee (1980)'s lenses.

Further scrutiny of the new EC CRA regulations suggests that the impact on some existing CRAs may be detrimental. The regulations may impose compliance costs which may act as barriers to entry (DeBellis, 2011). The barriers to entry therefore potentially negate Lee (1980)'s first key requirement above. On the second point above, the backdrop of the EC regulations was a period of deregulation where CRAs seemed to have previously wielded power and appropriated disproportionate advantages over their customers and other participants in general. It is therefore not clear whether the playing field will be levelled equitably for all players or if some powers will be taken away from CRAs thus equating to some transfer of benefits between CRAs and their customers, negating the second key requirement from Lee's (1980) key points above.

On Lee's (1980) third point above, the author makes a sound but idealistic assumption. As discussed earlier, in reality, regulators are themselves potentially self-interested players with economic or political agendas and hence their motivations may not always align well or serve the interests of all concerned. Extant literature reviewed so far (see for example Manaigo-vekil, 2011; Posner, 2010) suggested that there was a view that the EC CRA regulations were seemingly politically-motivated and therefore not equitable or just as Lee (1980) proposed. Consequently, the Just Theory of regulation seems idealistic and may not fit the EC CRA regulatory landscape.

This may be due to the traditional imbalances that the regulations aim to address, the self-interests of the different players (including the regulators) or indeed other reasons not discussed herein. An analysis of data obtained from interviews in this study will provide scope for further exploration of these concepts. The above discussions have focused on regulation in generic terms. Section 3.5 specifically considers securities market regulation, reviewing extant literature and drawing implications for this study.

3.5 Securities regulation

Following the corporate collapses of the 1930s in the US, new securities regulations were ushered in to restore market confidence and stem further crises. Several decades later, the global financial markets found themselves faced with similar predicaments, if not worse. The striking similarity was that the early 21st century failures were based on similar issues as the 1930s debacles (Zingales, 2009). This raised questions on whether regulation could in fact prevent economic collapses and market failures. There have not been many studies focusing specifically on securities regulation, particularly in the EU as regulations are a new phenomenon.

Recent developments surrounding the downgrading of sovereign ratings from a number of European Union members, coming shortly after the 2007-8 global financial crisis raised further concerns on credit rating agencies and their regulation (Eijffinger, 2012). This triggered more debates and studies investigating the workings of credit rating agencies in the EU. Table 6 summarises a selection of studies carried out before and after the 2007-8 global financial crisis. The selected studies highlight a number of key issues around securities regulation and will be discussed in more detail in the ensuing sections.

Table 6: Previous studies investigating securities regulation

Author	Details of study
Ford (2008/2010)	Conceptual study offering a critique of the rules-based approach to securities regulation. The author called for a more principles-based approach but backed with regulatory presence
Colombo (2010)	Lamented the dearth of trust in securities following the 2007-8 financial crisis. Argued that market participants had turned to regulation to restore market confidence as a way of bringing back trust which oils relationships.
Brummer (2010)	Regulations welcome but lack of a truly global, coordinated regulatory system was said to leave loopholes for disparate regulatory agencies risking future crises. Argued that as long as different states had individual, often competing interests, coordination of regulation would be difficult to achieve.
Zingales, (2009)	Analysed the causes of the 2007-8 crisis and concluded that this was centred on agency relationships; lack of accountability. Proposed reforms included corporate governance,
Langevoort (2008)	Argued that US securities regulators faced challenging regulatory choices regarding what measures to implement in the market to address fissures identified as having caused the 2007-8 financial crisis. The globalised nature of trade meant that they could only do so much.
Park (2007)	Conceptually reviewed the two competing paradigms in securities regulation; rules-based and principles-based approaches, arguing for a predictable and consistent regulatory approach that market participants could easily follow. The argument was that such a system was largely based on the rules-based approach, with clearly laid out expectations and guidelines.
Goshen (2006)	Argued that securities regulation played a crucial role in providing a conducive market for information traders by mandating disclosure and transparency to bridge information asymmetries. Took a view which assumed that industry was incapable of self-regulating and therefore needed external intervention.
Romano (1998)	Conceptual paper on securities regulation. Argued that the US approach to securities regulation was mistaken and likely to reduce market competitiveness through burdensome compliance costs and bureaucratic requirements

Source: Compiled by author

A number of themes emerge from the studies in Table 6 above. The themes centre on:

(i) Studies calling for securities regulation in general (Goshen, 2006; Colombo, 2010; Brummer, 2010)

(ii) Studies questioning the rules-based approach as manifested in the US regulatory approach (see for example Romano, 1998; Ford, 2008 / 2010)

(iii) Studies calling for a more globally-coordinated regulatory approach (Zingales, 2009; Langevoort, 2008)

(iv) Studies favouring a rules-based regulatory approach (see for example Park, 2007)

While previous studies (prior to the crisis) were largely calling for regulation of the securities market, studies post the crisis seemed to have changed focus, instead scrutinising the effect of regulation and calling for a more considered regulatory approach. Romano (1998) questioned the stringent rules-based US approach to securities regulation, arguing that this could hamper market competitiveness by imposing burdensome compliance costs. In a later study, Ford (2010) argued strongly against the new EU rules-based approach to regulating the securities industry, citing possible detrimental unintended consequences on innovation, timeliness of rules and regulatory competence among others. Regulation was portrayed as a process which had to be kept up to date rather than a destination with a finite ending.

Notwithstanding the critique of the rules-based approach, Ford (2010) also highlighted the weaknesses that characterised the principles-based regulatory approach prior to the 2007-8 financial crisis. The weaknesses allegedly emanated from the regulatory vacuum that meant that adherence to the stated principles was not effectively monitored or any deviations actively challenged. The proposal was for a cautious and balanced regulatory approach.

Separately, Langevoort (2008) analysed the precarious situation that US securities regulators found themselves in post the 2007-8 crisis. While on one hand the public demanded increasingly tighter regulatory oversight of the securities market, regulators themselves came under intense fire for having failed to be proactive in closing regulatory gaps in the period leading up to the 2007-8 crisis. The global nature of the securities market required a global approach and localised regulatory efforts could only achieve so much.

Zingales (2009) acknowledged the agency problems inherent in the ratings market and advocated corporate governance reforms to address the weaknesses identified in the securities market at both local and global levels. The two studies under this theme recognised the importance of a coordinated regulatory approach, particularly in a globalised world. Separately, Park (2007) posited two competing paradigms in securities regulation; the rules-based vs. the principles-based paradigm. In his evaluation, he concluded that market participants preferred a clear, predictable approach that offered understandable guidelines of expected standards.

Such a framework, the author argued was offered by the rules-based approach with prescriptive guidelines of what was expected. The challenge with Park (2007)'s conclusion was that the rules-based approach could foster the adoption of minimalist standards which could see market participants doing just enough to get above the regulatory threshold.

In a study, carried out after the 2007-8 crisis, Colombo (2010) welcomed regulation arguing that regulation could restore the trust that investors previously had in the securities market prior to the 2007-8 crisis. The conception of trust and its role in securities market relationships was perhaps overstated in this paper. Market participants need to be wary of blindingly trusting their counterparts. Instead they needed to be inquisitive and critically review any information presented to them by CRAs. In a tone similar to Colombo (2010), Brummer (2010) also welcomed the new securities regulations but lamented the absence of truly global and cohesive approaches to securities regulation.

From the above, arguably, the principles-based regulatory approach offers scope for innovation and flexibility, avoiding a "one-size-fits-all" approach. The principles-based approach is itself however susceptible to lack of legal enforceability leaving regulatory loopholes. Consistent with the above study, Goshen (2006) offered a critique of the role of securities regulation in financial markets and concluded that regulation was pivotal in evening out the playing field, creating conducive conditions for different players to participate. The author made a compelling case for information trading, calling for disclosure and transparency. This study, while offering a plausible call for regulatory intervention, fell short of clearly articulating the exact form and extent of regulatory interventions, a subject that has been picked up in studies post the 2007-8 crisis.

In a study post the 2007-8 crisis, Black, (2010) carried out an analysis of previous empirical regulation studies looking at 4 main areas:

1. Regulatory impacts on financial markets,
2. Financial market impacts on regulation,
3. Impact of market participants' contextual interpretation of different market players using regulation as well as
4. The dynamics of the regulatory regimes in operation across different financial jurisdictions.

The four areas above intersect although each gives a unique focus when analysed in more depth. One major omission from the above study was the fact that there was no focus on variations from the norm as driven by such things as corruption or regulatory capture together with requisite impacts.

Aside from the above selected studies, the 1980s saw the vast majority of studies seeking to measure the regulatory effects on individual firm behaviours. In investigating the impact of regulation, the dominant methodologies tended to be:

(i) Comparative studies looking at the regulated vs. unregulated markets and making judgements on the difference (time series analyses etc.)

(ii) Carrying out comparative studies in different political contexts or nations to look at variations

(iii) Employing use of experimental data for computations of regulatory effects.

The challenge with these approaches tended to be controlling for other variables so that the comparative studies considered like-for-like variables to be able to explain causality in regulatory phenomena. Also, there seems to have been inherent assumptions in these comparative approaches that considered the environmental regulatory effect as exogenous, when in fact regulatory initiatives may have been co-determined and endogenous. Further, contrary to inherent assumptions in the studies, regulations could have been lagging rather than leading the market. The next session considers regulation post the 2007-8 crisis.

3.5.1 Regulation after the crisis

Following corporate collapses and market failures, reformists tend to rush and implement new laws under the assumption that laws shape markets by channelling property rights, governing exchange relationships and covering resolution of commercial disputes. Alternative views however argue that markets drive laws and therefore laws simply rubber stamp what is already at play (Black, 2010). Shamir (2008); Garsten & Jacobsson (2007) expressed scepticism over regulatory intents, arguing that there were often covert regulatory motives bent on achieving private regulators' interests, with any public benefits being meagre offshoots of otherwise private agendas. This view is consistent with some theoretical conceptions of the public interest theory of regulation discussed in section 3.4.1.

Questions from this line of thought centre on whether regulators can be trusted to champion public interests or should there be further checks on regulatory players. This raises questions on what measures are taken by regulators to minimise regulatory burdens and maximise payoffs, issues explored in the next section.

3.5.2 Regulatory interventions and evaluation of regulatory impact

Depending on the form of regulatory interventions, the response from the regulated entities may be different. Consequently, effective regulation must balance between a number of often competing considerations to induce an appropriate, optimal regulatory response from the regulated entities. Regulators can choose between administrative and or criminal penalties in managing the behaviour of regulated entities. Administrative sanctions tend to be grounded in statutes and offer regulators flexibility to revoke contracts, cancel franchises and /or ask for the discontinuation of the undesirable practices, without having to rely on the courts for recourse or enforcement. This approach is therefore more conciliatory, empowering parties to engage in a more collegial relationship, emphasising equitable distribution of benefits.

The alternative criminal option may involve the levying of fines as a way of holding company directors responsible for the conduct of their companies or employees (Baldwin et al., 2012). Compliance may require regulated firms to address any identified misdemeanours within prescribed time frames, to certain stated levels; use of contractually-based measures such as suspensions, fines, and licence revocations among other penalties. Because firms are inanimate personae, use of imprisonment as a deterrent is not often effective (even though firm directors or proprietors can be held liable for their companies' misdeeds). Fines tend to be a much more widely used punitive method. The determination of the levels of fines has to consider the possibility of such fines being treated as normal business expenses and possibly being passed on to clients or even employees. Also, too hefty fines may disproportionately distort compliance costs and possibly drive some regulated firms insolvent. Equity fines are known to have been previously proposed as an alternative form of penalty for firms. This involves the firm or its shareholders being forced to give up (to the regulators) shares equivalent to the value of the penalty.

The advantage is that this approach does not see money removed from the corporation, with shareholding value being transferred instead. The approach may induce fear of possible takeover and compel good behaviour. The approach sees ownership becoming diluted as the state progressively owns more and more shares in the offending institutions with more fines being levied. The issues of conflicts of interest and participation in the regulated firm become prevalent as the state now gets involved in the governance of the regulated businesses. Other forms of punishment may include injunctions mandating firms to put right what they have done wrong as well as accountability orders where firms have to disclose their activities for the public to hold them to account. The issues with some of these approaches is that they assume that the market can distinguish good reporting from bad and that the market will self-correct based on disclosed information. The market tends to be fraught with information asymmetry. Even where firms have disclosed, consumers and other stakeholders may not understand the disclosed information to be able to make informed decisions about good or bad outcomes.

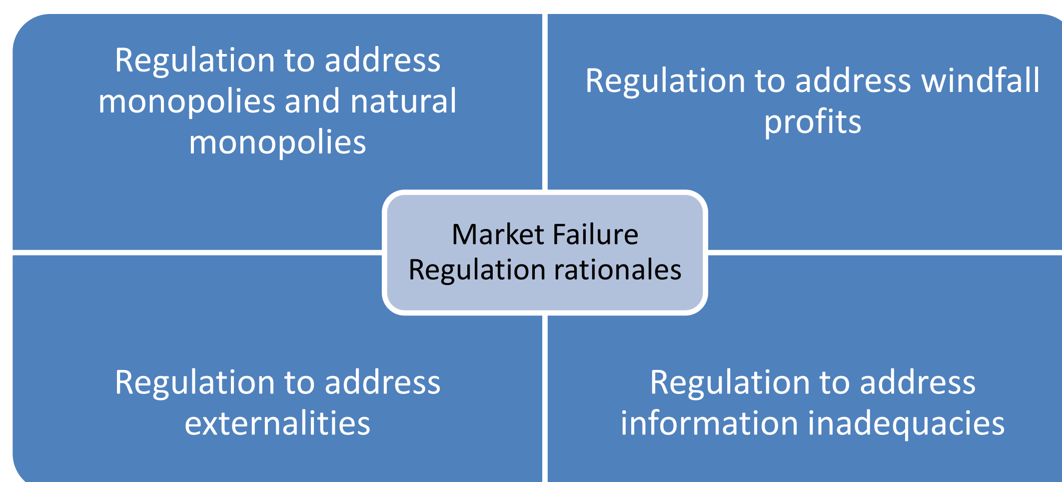
This questions the soundness of disclosure-based remedies which are often touted as a solution. Perhaps one of the most feared penalties for businesses is adverse disclosure (Van Erp, 2010). This may require errant firms to publicly acknowledge their misdeeds and state what they are doing to remedy them. It does not come without its weaknesses though. Firms can be creative in how they disclose so that the cost of doing so may still be below the benefits of their errant behaviours. In considering regulation and the different forms that best address market issues, it is important to always relate back to the rationale for regulation, an issue which is explored below.

3.5.3 Rationale for regulatory intervention

In discussing regulation, it is imperative that the objective of regulation is distinguished from its rationale. Regulation objectives look at what the regulation seeks to achieve, while the rationale focuses on the reasons for regulation. Financial and capital market regulation needs to be geared towards clearly articulated regulatory objectives, with clearly defined deliverables so that its implementation can be measured against such. The reasons for regulation need to be convincingly articulated.

Baldwin et al., (2012) identified eleven market failure rationales for regulation. Four of these have been identified as relevant to this study and are visualised in Figure 3.

Figure 3: Rationale for regulatory intervention



Adapted from Baldwin et al, (2012, p15-21)

Ideally, market competition should corral market players towards well-functioning, equitable market systems where inefficient players are driven out and standards raised. This assumption is largely hinged on the market being knowledgeable and information being symmetrical. Often, this is not the case, the forces of supply and demand do not always work (or may not always work well and / or quick enough), leading to market failures that in turn necessitate government intervention as a way of enhancing prudential risk management (Crockett, 2003). In discussing the role of regulation, Professor Gower once wrote "regulation should not seek to achieve the impossible task of protecting fools from their folly, but instead, should aim to be no greater than is necessary to protect reasonable people from being made fools of"(Gower, 1984 cited in Lightfoot, 2003, p. 88).

There are connotations in Gower's statement about the potential danger of regulation being too cumbersome and unreasonable, potentially leaning towards a nanny regulatory state. Commenting on financial market regulation well before the 2007-8 crisis, Goodhart, Kay, Mortimer, & Duguid (1988, p.7) emphasized that financial market transactions were the key ingredients of making profits or acquiring capital and therefore:

"…it follows that in order to devise an efficient system of regulation, it would be necessary first to obtain a thorough knowledge of these markets and their economic purpose and effects. It may however come as little surprise to the reader that this was not the approach adopted"

This statement was written with particular reference to the 1980s regulatory reforms but it still strikes a familiar tone when considering several misgivings on the heated debates around the subject of regulation in general (Becker, 2011); the recent European Regulations on Credit Rating Agencies in particular, and regulators' perceived competences in fashioning the EC regulations post the 2007-8 global financial crisis. When enacting regulatory frameworks, it is futile and self-defeating to set regulations whose impact outweigh perceived benefits (Gower, 1982). This calls for concerted efforts prior to enacting any regulations to assess the possible benefits and possible costs that may result from the regulatory initiatives (Lightfoot, 2003).

If regulations are not well-thought through, they may have adverse effects on the market. Lightfoot, (2003) cited the US Glass-Steagall Act of 1934 as one example of a kneejerk reactive regulatory initiative that was "ill-conceived and potentially costly" (p.91), crafted as an immediate impulse reaction just after a financial crisis. Despite its weaknesses, there are others however who argue that the repeal of the Act led to "the development of a shadow banking system" (Sy, 2012, p.76) and the subsequent financial crisis, asserting that despite its weaknesses, the Glass-Steagall Act served as a deterrent while it was in force. The conclusion from the above arguments is that despite the fact that some regulations may not have been well-crafted, they may still act as deterrents and go some way in changing market relationships.

Regulators cannot completely remove financial risks, but rather, they can "attempt to reduce their number, duration and spread, mitigating their immediate consequences, particularly for innocent bystanders" (Davies, 2003, p.29). While in theory, regulation can be said to benefit the market, reality has often seen political and government interests driving regulation, (Benston, 1998). To legitimise their regulatory and political pursuits, politicians often cite such problems as lack of competition to justify the need to regulate (Brand, 2005).

Despite the political nature of some regulatory pursuits, grounding them in market-related problems legitimises and justifies the regulatory activities. Singer (2007) reiterated the fact that financial regulators' motivation to regulate largely stemmed from their positional power and the need to be seen to be in control, particularly when there was a perceived market failure requiring intervention. This was said to have the tendency to be reactive, sometimes falling short of accurately scoping the full impact of resultant regulatory initiatives.

Notwithstanding the above, the link between politics, finance and regulation is not far-fetched (Helleiner, Pagliari, & Zimmermann, 2010). Such a link is critical in the design, implementation and review of securities regulation. Alternative regulatory approaches include those that advocate common interest regulation (Mattli & Woods, 2009). This approach advocates an inclusive orientation to negotiating regulatory reforms, freely disseminating information for equitable access to all concerned stakeholders and embracing their input. This culminates in a shared construction of regulatory reforms. This approach would balance the needs of different stakeholders. It is not without its weaknesses though. For a start, it assumes sufficient levels of interest and understanding of regulatory issues by different stakeholders, which in reality is rarely the case. Secondly, it is difficult to imagine how the model could be deployed in practice: who would the stakeholders be? What criteria would be used to delineate who is in and who is out? How would conflicting interests be managed for example? Such questions put a damper on this approach and challenge its sole adoption, relegating it to be perhaps only a part of whatever solution is proposed. The purpose of regulation is to alter the behaviour of targeted players, although this is a contentious issue centred on how far behaviour can be regulated.

There are two types of regulatory approaches in the financial sector, namely structural / prudential regulation and conduct of business regulation (Llewellyn, 1999). The first looks at the viability, solvency and general soundness of financial institutions and markets, while the latter focuses on how financial institutions transact with their clients. This study primarily focused on the first. Prudential or structural regulation is necessary owing to inherent information asymmetry issues, agency problems and conflicts of interest issues among other challenges.

Writing specifically about the regulation of Credit Rating Agencies, (CRAs), Langhohr & Langhohr (2008) acknowledged the pivotal role of CRAs in distributing and sanctioning information which forms the cog that drives global securities markets, as well as the regulatory reliance on credit ratings by state regulatory institutions. This, they juxtaposed to the risk of private shareholder-driven rating agencies whose revenue models ostensibly motivated them to internalise benefits derived from their role, while externalising any resultant negative costs. Regulation in the context of CRAs and other similarly-positioned entities therefore was aimed at imposing "regulatory constraints on behaviour aimed at maximising private value in order to reconcile this with the public interest," (Langhohr & Langhohr, 2008, p.429).

There are two camps typically either pro or anti-regulation. On one hand, regulation is often perceived as playing an enabling / facilitating role (green light regulation). On the other hand, regulation also plays a curbing / restricting role, aimed at inhibiting certain behaviours (red light regulation). The role of regulation particularly in financial markets is said to be largely anchored on the four tenets espoused by Llewellyn, (1999) and shown below:

1. The workings of financial markets and institutions,
2. Incentive arrangements driving behaviour among financial players
3. The level of market imperfections and mandate of regulators to tackle these
4. The uniqueness of financial arrangements (i.e. not the same as other goods and services which enjoy less regulatory oversight)

Well-designed regulatory incentives "will induce appropriate behaviour and workings of regulated firms. Conversely, if the incentives are badly constructed and inappropriately applied, they might fail to reduce systemic risk, potentially leading to undesirable side-effects such as unnecessarily raising the price of financial services" (Llewellyn, 1999, p.7). The question of appropriateness is very contentious and requires careful evaluation, considering the needs of all stakeholders, consequences of regulation (both intended and unintended) as well as the cost or impact of regulation.

According to Hutter (1997) the regulatory process seeks to change behaviours through three interlinked stages of formulating the requisite regulatory rules, establishing the regulatory administrative functions as well as enforcing and monitoring the formulated regulations. This is a cyclical process which is iterative in nature, allowing for regulators to keep revising and refining each stage iteratively. The cyclical and iterative nature of the process acknowledges the dynamic nature of the regulatory climate, allowing for regulators to respond to regulatory demands in a timely fashion. The next section discusses different approaches to regulation.

3.6 Regulation approaches

A number of regulatory approaches have emerged over the years. These are risk-based, responsive and smart regulatory approaches. The approaches though different, overlap in a number of areas (Baldwin et al., 2012). A brief synopsis of each of the approaches is given below.

3.6.1 Risk-based regulatory approaches

Risk-based regulation emphasises the avoidance or minimisation of risk through requisite regulatory intervention and is often regarded as the backbone of modern regulation theory. Risk-based regulation uses risk analysis and comprises three elements namely; risk assessment, risk management and risk communication. The element of risk management is further broken down into standard setting or the formulation of requisite codes on one hand and control on the other. The control element focuses on the enforcement of the set rules.

The challenge with risk-based regulation is that it is as comprehensive as the information available for the risk analysis. Looking at the EC regulations, an attempt seems to have been made to follow a risk-based approach, albeit retrospectively. The challenge with a retrospective application is that the regulation blueprint is based on the previous crisis and may not help identify and prevent subsequent crises in a proactive manner.

3.6.2 Responsive regulation

This regulatory approach responds to the behaviour of the regulated entities (Ayres & Braithwaite, 1992). It follows a pyramid structure with soft, persuasive regulation at the bottom of the pyramid, gradually toughening as one goes up the pyramid, responding to escalating cases of non-compliance, culminating in licence revocations at the pinnacle of the pyramid.

The approach allows for tailoring of regulatory approaches to respond to each regulatory situation, allowing for flexible movement up or down the pyramid to avoid heavy-handed regulation.

3.6.3 Smart regulation

Referring to environmental regulation, (Gunningham & Grabosky, 1998) asserted that both responsive regulation and risk-based regulation fall short of desired levels when a multiplicity of actors are considered, requiring not only different approaches, but a variety of regulatory instruments as well as the need to avoid a 'one-size-fits-all' approach. Smart regulation largely hinges on active communication and participation between parties concerned to encourage involvement even at the lowest levels as opposed to imposing regulations from the top. By co-opting and involving all stakeholders, smart regulators foster a sense of shared responsibility and ownership thus improving compliance by utilising existing structures rather than reinventing the wheel. Active consultation ahead of the regulatory initiatives as well as during implementation becomes key, to gauge participants' moods and make necessary adjustments where necessary. This approach will be applied to the EC regulations to determine if there is a fit between the EC regulations and the conception of smart regulations.

3.6.4 Rationale and focus of this study

This study focused on securities regulation, concerning itself with "securities, debt, and derivative instruments, and the markets" (Black, 2010, p.3). Kay & Vickers, (1990) distinguished between structural regulation (i.e. regulation aimed at aligning the structure of the market) as opposed to conduct regulation, which comprises regulatory efforts aimed at regulating market behavioural issues such as pricing, quality among other things.

Because of their broad objectives, the EC regulations seem to have straddled both these areas owing to their multiple aims of addressing competition issues by eliminating entry barriers (structural regulation) but also focusing on enhancing transparency through disclosure; promoting timely issuance of quality ratings etc, which would fall under conduct regulations. These multi-facetted objectives pose challenges for the EC regulations, raising questions on their effectiveness as well as the possible impact on market participants and market operations. The next section looks at the different regulatory players and considers what role they play in regulatory enforcement.

3.7 Regulatory players

As discussed above, the regulatory role can be performed by many different players including but not limited to central government departments, regulatory agencies (government-sponsored or private), parliament, local government, self-regulators (voluntary or coerced), directors general as well as courts and tribunals (Baldwin et al., 2012). Globalisation has seen a proliferation of new forms of intergovernmental regulatory structures, drawing mandates from different subscribing governments to ensure international coordination of regulatory efforts. This renders the regulatory field complex as new forms keep emerging and need to be carefully evaluated. The different regulatory players are discussed below.

3.7.1 Central government departments as regulators

Ministerial departments accountable to parliament are often used as regulators. They however suffer criticism owing to their allegiance to the political establishment that nurtures them and the fact that their lifespan may be limited to that of the parent parliament thus affecting continuity. Bureaucratic tendencies and levels of expertise together with efficiency in regulating market issues by central government agencies are often questioned. Further, the public may not see such regulatory structures as independent enough to effectively address issues arising from what the public may see as failure by the same government sponsoring the regulatory entities. Such concerns have encouraged the consideration of alternative regulatory agencies discussed in the ensuing sections.

3.7.2 Regulatory agencies

Regulatory agencies act on behalf of government to regulate specific sectors such as OFGEM in the UK electricity and gas markets; FSA in the UK financial services among others. Through the mandate given to them by central government, these regulatory agents become the supposed specialist overseers of the allocated sector, devising and enforcing rules as necessary (Baldwin & McCrudden, 1987). Perhaps their greatest strength is said to be the independence from government and the relevant ministry that sets them up. Regulatory agencies are duly constituted with independent governance structures ensuring that they are impartial in adjudicating on matters in their watch. Unlike ministries, they are more enduring as their life can span across different governments or parliamentary administrations.

3.7.3 Parliament as a regulator

Parliament can pass bills specifically aimed at regulating allowable conduct in particular industries. In the UK, parliamentary involvement in regulation dates back to the Gladstone regulations on Railways in 1844 (Baldwin & Cave, 1999). Parliamentarians form specific committees tasked with regulating identified areas. The challenge with this approach is that parliamentarians may ignore advice by industry practitioners, resulting in a gap of understanding between regulators and industry. Such a situation may lend itself to regulatory capture, particularly where there are conflicting interests between parliamentarians and the regulated area.

It is not uncommon for parliamentarians to be found straddling personal, political, and financial interests on one hand and regulatory interests on the other. A good example of this may be the conflicting role of peers in shaping legislation on one hand but also serving the interests of paymasters or sponsors in the regulated areas on the other (Shell, 2008; Strauss, 1964). Because of these and other problems, parliamentarians seemingly play less regulatory roles, devolving such to others such as local authorities.

3.7.4 Local authorities as regulators

Structures such as municipalities, police and other local bodies sometimes carry regulatory powers. In the past, this was prevalent in the UK. Local authorities tend to be best positioned to play a regulatory role on issues requiring local participation or input and their knowledge of local issues, enabling them to connect with local constituencies easily compared to central governments. Challenges arise however where such regulations have to be coordinated nationally or where there are conflicts of interest which may give rise to regulatory capture because of the close relationships between regulators and other regulated interests at a local level.

3.7.5 Self-regulators

A major observation from the historical account of credit rating agencies presented in chapter 2 was the absence of, or ineffectiveness of a self-regulating market mechanism within the credit ratings market. Such a void coupled with various crises can be a recipe for regulatory intervention which seeks to address market failures. Such failures would have arisen from imperfections in the market linked to information asymmetry (Laffont, 1994). This involves organisations setting regulatory parameters and behavioural codes for their members, (Black, 1996; Gunningham & Rees, 1997), often at voluntary or informal local levels. It is not uncommon though for such self-drawn regulations to be overseen or enforced by governments, thus raising the questions of the accuracy of the concept of the 'self' when it is government that regulates (BRTF, 1998).

Self-regulators still play active roles in regulating entry into professional and industry fields, setting codes of conduct and enforcing compliance thereto, among other things. Self-regulators may draw their mandate from relevant government statutes, giving them even more power. Their proximity to industry issues gives them a clearer view of the major regulatory issues involved at local operational levels. They tend to be innovative and adaptive and can speedily come up with rules or codes to respond to topical issues in the area in question. Considering the fact that in the majority of cases, regulation is used to try and balance private firm interests with public interests, there is a question around the legitimacy of self-regulators in representing the views of others outside the industry.

This is particularly because such self-regulators do not have a mandate to represent interests outside their organisations, questioning their commitment to public interests. Further, it is questionable how the public can be assured that broader public interests are served by self-regulators whose interests may be narrowly-defined. Lastly, there may be questions of independence of a regulator set up by members of the regulated community and how such a regulator can be effectively monitored or held to account by government or the public. Black (1996) divided self-regulators into four groups, demonstrating the state's involvement at varying levels across the four groups. The groups included sanctioned, coerced, mandated and voluntary self-regulators. This categorisation was further developed by (Bartle & Vas, 2007) into two broad groups; mandated and non-mandated self-regulation.

Mandated regulation incorporates 3 further categories; cooperative regulation – where the regulated entities and the regulator jointly develop and implement statutory regulation; Delegated regulation – where public authority regulatory bodies delegate the implementation of regulation to self-regulatory bodies, and finally, devolved regulation – where the government and / or parliament crafts regulation but pass it down to self-regulatory bodies for implementation.

The second category by Bartle & Vass (2007) was that of non-mandated self-regulation, which also comprised three forms: Facilitated regulation – where the regulatory scheme is not statutory but is actively supported by the government; Tacitly-supported regulation – where the state is not involved in self-regulation but tacitly encourages it; and finally, voluntary self-regulation where seemingly self-regulatory bodies act independently and out of their own volition but in reality are constrained by the state in some form. The bottom line from the above regulatory guises is that the self-regulatory landscape is not straightforward, but may involve various forms and players, all interacting for different outcomes. Self-regulation is thus not as straightforward as organisations voluntarily coining and enforcing their own codes to regulate members. Neither is it a clear dictatorial coalition where the state plays big brother on self-regulators. Rather, it tends to be a blend of the two with different positions along a continuum depending on what the regulatory issues are, the organisations involved, political agendas, public appetite and levels of involvement (Gunningham & Rees, 1997).

3.7.6 Co-regulators

Ayres & Braithwaite (1992) referred to co-regulation as an arrangement where industry self-regulated but within a framework negotiated and attested to by relevant state regulatory agencies. This view was further developed by Pattberg (2005) who noted an increasing trend of the privatisation of world politics and with it, the shift from public regulatory institutions towards negotiated regulatory settlements between profit and non-profit players, particularly at an international level. This view is significant particularly when taking into consideration the role and power of private institutions in today's globalised markets and their propensity to privatise profits, while externalising negative externalities (Hertz, 2001).

The aforementioned view therefore regards co-regulation as suspect, while other views (see Pattberg, 2005) are more positive, seeing co-regulation as tapping into regulatory capital of the different players to minimise regulatory collateral. There are useful possibilities of this approach in reducing regulatory information gaps and reducing regulatory oversight costs, particularly in a market characterised by complexity where regulators struggle to keep up with the innovative dynamism of the regulated market (Winn & Jondet, 2008). Further, this concept is extended to include other participants who may contribute from a consumer or service user perspective, ensuring that the resultant regulation does not ostracise the very people it is meant to protect.

3.7.7 Courts and tribunals as regulators

The use of courts and tribunals adopts a judicial approach to regulation and follows legalistic proceedings such as hearings and trial-type representations in dealing with market issues. Courts are effective as enforcers and interpreters of regulation but still rely on other players to craft the relevant regulations (Crawford, 2010). Such regulatory approaches are often criticised for lacking adequate knowledge particularly in dynamic, information-based and politically-sensitive environments where things constantly change. They are said to lack connection with issues on the ground, using legalistic approaches in often fluid situations that are probably best tackled using other more conciliatory means. Further, courts and tribunals are said to be largely reactive, managing the aftermaths of regulatory failures rather than preventing failures before they happen (Pistor & Xu, 2005).

Notwithstanding the above limitations, perhaps courts are a necessary partner in enforcing regulation, particularly where there has been errant behaviour, to bring culprits to book as a deterrent for future would-be offenders.

3.7.8 Directors general as regulators

These are single individual regulators appointed by the Secretary of State (in the case of the UK) to regulate particular industries, assisted by dedicated offices such as the Office of Water Services (OFWAT) or the Office of Telecommunications (OFTEL) among others (Baldwin et al., 2012). The Director General is accountable to the government through such structures as the Comptroller General or the Public Accounts Committee among others.

In exercising their regulatory role, directors are mandated to consult on issues that may result in significant changes to their regulated entities. Director Generals were said to be advantageous as the public had a single named individual tasked with protecting their interests. Such an individual was said to operate relatively flexibly, without much bureaucratic hindrance as would be found in more complex government regulatory structures. In many instances, Director Generals tended to be superseded by commissions, broadening the responsibility beyond a single individual (Baldwin et al., 2012).

Despite the above different forms, the globalised world today is encountering a different form of regulator, one that straddles national political boundaries, the international regulator. This poses new challenges of coordination, legitimacy, power bases, conflicts of interest as well as regulatory responsiveness to local and or international issues (Klöhn, 2010).

Challenges besetting the European credit rating industry have been attempted at national levels but without much success (Langohr & Langohr, 2008). The globalised nature of the financial markets makes it difficult to isolate a particular country or player and contain the targeted phenomenon within fenced financial or securities markets. Business deals are contagious due to the nature of global trade. Effective solutions need to be end-to-end, i.e. from the origin countries right up to the destination countries.

Such a role can only be performed by a legitimate and properly mandated international / global regulator. This new regulatory player is discussed briefly in the following section.

3.7.9 International regulators

With many businesses operating across multiple nations, there is need for a regulatory approach that coordinates activities beyond country level to keep up with the new forms of multinational and global corporations (Farrell & Newman, 2010; Jackson, 2010; Lipuma & Koelble, 2006; Nielo & Peñalosa, 2004). This calls for collaboration at inter-governmental levels as well as organisations themselves understanding the impact they can potentially have on different stakeholders and taking proactive steps to address these.

The challenge with this new regulatory order though is the coordination and synchronisation of national political and economic agendas (Helleiner, 2009; Klöhn, 2010) which may be competing against each other both politically and economically, making collaboration difficult. Further, international regulators tend to suffer from legitimacy problems (Picciotto & Haines, 1999), particularly as they are not directly elected by the different state constituents that they preside over. International regulators also suffer from lack of detailed local market knowledge which compromises their effectiveness to preside over detailed local country issues. Consequently, they may just be responsible for crafting and coordinating the requisite regulations but leaving the enforcement and monitoring regulatory functions to locally-based regulatory agents who may be more attuned to local issues (Acharya, Wachtel, & Walter, 2009).

To their advantage, international regulators can perhaps exhibit better independence and objectivity in aligning the often diverse interests of different local and international stakeholders, (assuming they do not have any allegiances to individual stakeholder entities or countries). Also, their broader remit may allow them more scope to tackle issues that are widespread across the regulated landscape, giving them the advantage of tracking and tackling issues at source without any jurisdiction challenges. International regulators however suffer from the lack of local reach, making them ineffective at local market levels.

Further, their mandates may be questioned as these tend not to be grounded on local electorates. While there has been a move towards international regulation, there are still questions about the sectoral nature of some regulatory initiatives such as the European Commission Credit Rating Agency Regulations. The concern is that such a localised regulatory approach further fragments the global market and hinders global coordination, at a time when perhaps the trend should be going the other way (Davies & Green, 2008). Viewed from a different angle, regional regulation may form building blocks towards a global regulatory coalition and depending on the regulators, may allow for both a local focus as well as an international and global reach.

The UK regulatory landscape is in transition. With the impending dissolution of the FSA, a three-pronged regulatory approach has replaced the FSA. Potentially, this may further alienate regulators and leave gaps in the system. On the other hand, perhaps this approach will ensure each regulatory arm is focused and competently equipped to deal with issues within its jurisdiction. The sheer number of international regulatory players in financial markets and the touch points in the exchange of information represent significant challenges of coordination, assimilation and translation to ensure common understanding. With ESMA now regulating the activities of CRAs in the UK, IOSCO seems to have lost its grip on the European continent. Further, the EC regulations seem to have gone further than their US counterparts, raising questions on how this can be harmonised to prevent unintended consequences in the European Union.

3.8 Measuring the impact of regulation

Perhaps one of the most important tests for any regulatory initiative is whether the regulations achieve their originally-stated purpose. Regulatory effectiveness looks at the extent to which regulations deliver their stated objectives. As there are different stakeholders with potentially diverging interests and expectations, it is crucial that from the onset, regulatory objectives are clearly stated so as not to cloud implementation later on. The notion of regulatory effectiveness raises questions about what can be considered good regulation. Section 3.8.1 below discusses theoretical concepts surrounding regulatory proposals to derive a conceptual template of what can be considered to be good regulation.

3.8.1 What is good regulation?

The notion of what constitutes good regulation is a contested one and should be examined in conjunction with how well the regulations achieve what they were set to achieve (Baldwin et al., 2012). According to Kling, (1988), a successful theory of regulation needs to balance between requisite regulatory costs and benefits, as well as recognise the political system which ushers in such regulations. This helps to balance potentially competing interests that shape policy and the resultant regulation. In her 1988 paper, Kate Mortimer argued that the often blanket nature of regulation, affected even the good market players and imposed unwarranted costs on the good ones, when it was the bad ones that regulation should have been aimed at, (Goodhart et al., 1988).

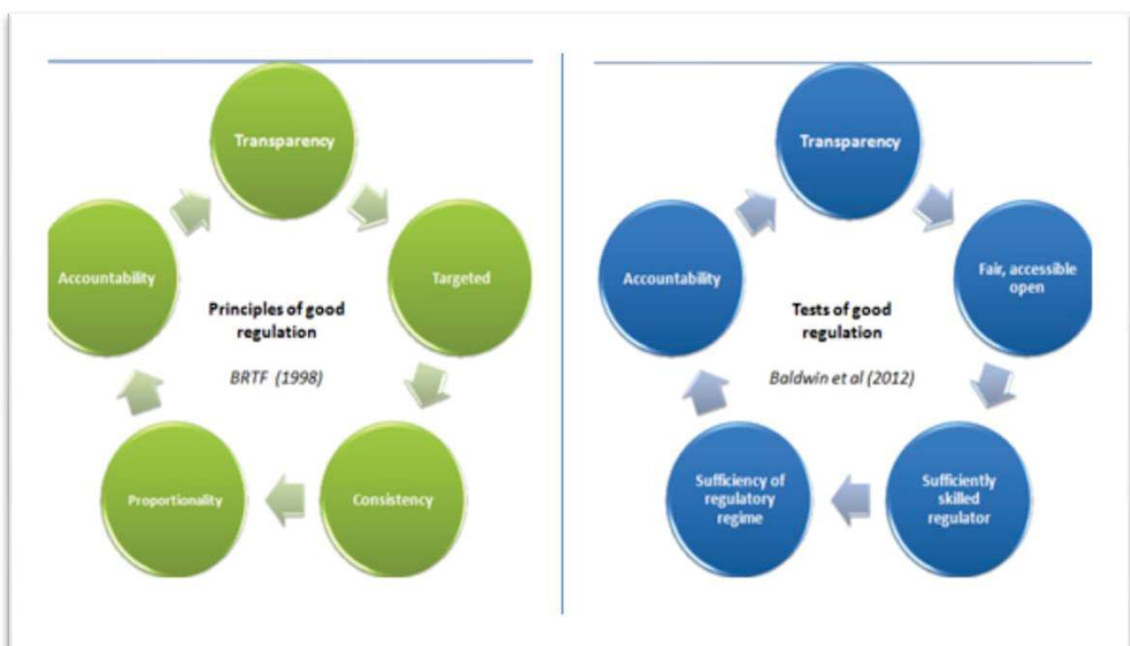
Davies and Green (2008, p.14) argued that "regulatory intervention should only be justified where the benefits clearly exceed the costs imposed." To determine what good regulation is, costs and benefits of the new regulatory reforms need to be computed and compared. Regulators also need to aim to reduce regulatory burdens and be cognisant that no regulatory form will work perfectly without some problems. This poses significant challenges for regulators who have to quickly react to situations, often in very unclear environments where there could be unintended consequences, whichever move they take. There is often a tension between the ethical schools of thought (Dworkin, 1980) and the efficiency view of regulation (Posner & Scott, 1980). The former was said to be aligned to the allocation of rights and considered judgmental issues of justice and fairness, while the latter simply concerned itself with economic efficiency and distributional wealth maximisation.

The two positions seemingly cannot stand when viewed in isolation and treated as mutually-exclusive considerations; rather a balance of the two may present a workable compromise. This means that in addressing economic wealth maximisation issues, market participants are often being called to address broader, softer issues related to what is commonly known as the triple bottom line (Pava, 2007). The triple bottom line principle asserts that businesses need not only concern themselves with profits or wealth maximisation, but should balance this objective against broader social sustainability considerations on one hand, and environmental sustainability on the other.

A sustainable organisation from this definition would be scoring well on Profits (economic wealth maximisation); Planet – environmental sustainability as well as People – social sustainability, hence the triple bottom line. Seemingly, good regulation must recognise and address the complex and interdependent nature of market issues. For example, capital adequacy becomes weakened if accounting standards and auditing norms are flawed (Crockett, 2003).

This calls for a systemic approach by regulators to ensure that regulation does not just displace risk, but mitigates it on the whole. The Better Regulation Taskforce (BRTF, 1998) identified 5 key principles of good regulation. These are summarised in the first left half of Figure 4. Good regulation according to the above principles must be proportional to the market problems that the regulations seek to address; regulations must not be an overkill or be burdensome. Regulatory objectives and requirements must be clear and the regulatory efforts must be clearly targeted at those areas requiring attention rather than take a blanket approach. There must be clear lines of accountability with a consistent approach to the application of the regulatory regime. Figure 4 shows tenets of what is considered to be good regulation (BRTF, 1998; Baldwin et al, 2012).

Figure 4: Tenets and principles of good regulation



Adapted from (BRTF, 1998; Baldwin et al., 2012)

According to Baldwin et al., (2012, p.32) good regulations must meet 5 criteria set out in the second right hand side half of the figure above. The authors concluded that the above five "are the rationales that are employed and have currency in real-life debates on regulation and its form. Arguments in support of (or arguments criticising) regulators that do not fall under these five headings will be deemed irrelevant by most members of the public" (p.32). Justifications based on evidence drawn from across the five headings discussed above give a useful framework for evaluating regulatory proposals. Most regulatory debates tend to focus on whether any trade-offs can be managed between the five criteria espoused by Baldwin et al., (2012). The adoption of an evaluation criteria based on the five tenets of good regulation avoids issues of moral correctness or legality of regulation to concentrate on the merits and demerits of such regulation based on the worthiness of public or stakeholder support.

3.8.2 Regulatory quality

Regulatory quality is dependent on how well the regulation delivers on policy objectives as well as on the specific benchmarks that have been set (Weatherill, 2007). Measuring regulatory quality can be contentious and subjective, with different jurisdictions focusing on different regulatory aspects such as outcomes and net benefits to citizens (USA and Canada); focus on regulatory complexity and regulatory burdens (Belgium) among others. Each jurisdiction needs to determine beforehand what quality would mean and thus set appropriate measures for requisite regulations against whose set quality parameters the new regulations would be judged.

Within the context of the EC CRA regulations, there is need to view rating agencies within a broader systemic field occupied by multiple players influencing each other. It is also key to understand who the key drivers are in the field and how these can be leveraged upon for maximum regulatory impact. For regulations to take effect and bear fruit, they must be given ample time to do so. The rapid amendments of the EC regulations, (from CRA1, CRA2 through to CRA3) have been too quick and drastic. Regulators may need to take a step back and review the impact of their recent actions before rushing through the next raft of changes. The next section discusses the balance between regulatory costs and benefits.

3.8.3 Calculating the costs and benefits of regulation

There is a tension on how best to evaluate the true benefits of regulation. Proposed approaches range from Cost Benefit Analysis, (CBA), Compliance Cost Assessment, (CCA) or Regulatory appraisal. CBA considers the total costs and benefits of regulation and demands that there should be a surplus of benefits over costs to justify regulation.

The CCA outlines costs to be incurred in complying with regulation and is aimed at informing regulators of the impact of different regulatory options on the regulated entities. This helps in justifying the chosen alternative by outlining benefits on one hand, versus compliance burdens on the other (Baldwin et al., 2012). Appraisal approaches emphasize holding up regulatory options against the tenets of good regulation discussed earlier, ensuring that regulatory proposals are measured against clearly set criteria as a way of building an objective business case. The challenge behind economically impact-testing any regulation is the quantification of costs or benefits. How do the positives or negatives of any regulation fit into a monetary value for objective assessment? Some regulatory impacts / costs may be hidden and not so obvious, making it difficult to quantify them. Further, in quantifying regulatory impacts and giving out a monetary value, are we not debasing moral and ethical values and reducing them to monetary denominators? Does this suggest that unless benefits or costs are expressed in monetary terms, they may not be understood or valued?

The appreciation of regulatory impacts may be different between professionals and lay people and this sometimes causes tension on which regulatory approaches get pushed through (Pildes & Sunstein, 1995). Sometimes the very process of measuring regulatory impact becomes so cumbersome and costly that it poses bureaucratic and cost challenges to fully appraise regulatory proposals. Even when regulations have been implemented, accurately measuring the true impact of regulation may be difficult or impossible owing to creative compliance or inclusiveness. These ideas are explored briefly in the ensuing sections.

3.8.4 Creative compliance

At times regulation fails to achieve the desired regulatory objectives because the regulated entities begin to circumvent the regulations, avoiding to break the law but still not fully complying with the regulations (McBarnet, 2006). Regulated entities may change form or processes and appear to have complied when in reality they have not. In this case, regulatory costs may go up as regulators attempt to reassert themselves in the market. A typical example would be the requirement for regulated entities to pay their corporation tax. To avoid paying too much tax, they may beef up their expenses thus making it difficult for the taxman to pin down any wrongdoing.

Creative compliance takes a great deal of effort, resources and attention to detail on the part of the regulator. Where the regulator's knowledge of the regulated market is limited, they may struggle to identify any non-compliance and the negative effects of errant behaviour can continue to manifest themselves despite the presence of regulators.

3.8.5 Regulatory inclusiveness

In designing regulations, legislators have to balance between coining rules that are either under-inclusive or over-inclusive, i.e. some regulations can be either so general as to be ineffective and not targeted at any specific issues on one hand or be too detailed, nit-picky, cumbersome and over-prescriptive on the other hand (Baldwin & McCrudden, 1987). In the former, rules or regulations are loosely designed and may miss out key issues. In the latter, regulations are drawn up to try and cover different possibilities as much as possible but without being specific on any particular issues, possibly owing to regulators' lack of detailed understanding of the real issues and how to address them. This may be an attempt to appease political agendas or to avoid discretions and be seen as applying similar standards to all situations (Baldwin & McCrudden, 1987). These two scenarios are often a result of high information costs, meaning that it would cost more to gather tailored information that allows for the specific identification and targeting of the problem. Consequently, general or too detailed rules may be applied and in both cases, this may not achieve the desired regulatory objectives. Rule-makers in both instances above shift costs to enforcers as they now grapple with issues arising from ill-drawn regulations.

Regulation positioned on either of the two extremes (over-inclusiveness and under inclusiveness respectively) may lead to what Shrader-Frechette (1991) described as Type I and Type II risks. Type I risks are producer risks, while Type II are consumer risks. In coining and enforcing regulations, regulators may either emphasize the protection of consumers or producers. If in doubt, Shrader-Frechette (1991) argued, regulators would fare better if they protected consumer rights as opposed to aligning themselves with producers and safeguarding producer rights, after all the bulk of political electorates are consumers.

There is also the issue of regulators being divorced from market issues which may impair their ability to regulate effectively. Commenting on this, Armstrong and Sappington (2007) asserted that:

> *"... In particular, the regulator typically has less information about such key industry data than does the regulated firm(s). Thus, a critical issue is how, if at all, the regulator can best induce the regulated firm to employ its privileged information to further the broad interests of society, rather than to pursue its own interests" (Armstrong & Sappington, 2007, pp.3)*

This idea was echoed by Alan Greenspan (cited in Davies and Green, 2008, p.20) who reiterated that "regulators can still pretend to provide oversight, but their capabilities are much diminished and declining.." he went on to concede that he and his colleagues "increasingly judged that we would have to rely on counterparty surveillance to do the heavy lifting."

One would hope that the above sentiments represent more exceptional and rare regulatory situations than the norm. The assumption that counterparty surveillance can work is perhaps hinged on the notion of such counterparties being themselves knowledgeable and being able to acquire and process market information competently. It goes back to the issues of supply and demand where the invisible hand of the market guides prices in the market. As has been highlighted, this often fails, particularly where there is information asymmetry which seems to persist in the ratings industry. Greenspan's assumptions thus give a very grave reassurance of where regulators take their comfort.

3.8.6 Regulatory subversion

Regulatory effects often cause some market players to devise ways of subverting the regulatory process for private gain (Glaeser & Shleifer, 2003). Each regulatory framework with time may succumb to subversion as economies continue to innovate and market participants devise new ways of dealing with regulatory constraints. Regulatory subversion suggests that alternative frameworks need to be constantly evaluated to adapt regulatory arrangements and ensure that they remain fit for purpose. Further, subversion may come in the form of powerful corporations manipulating regulation and regulatory agents to suit their own internal purposes (Koenig, 2004).

Regulatory subversion may be tantamount to regulatory capture, where regulators eventually begin to sympathise with the regulated entities and fail to represent public interest issues (Laffont, 1999). Effective regulation must therefore be constantly scrutinised for its vulnerability to the above challenges to ensure that the process remains viable, delivering to its originally-stated objectives. There are therefore many questions that need to be teased out on the EC CRA regulations to determine how well the regulations deliver on the stated objectives. The fact that the regulatory initiatives are new does not give ample time for a comprehensive evaluation of their impact. A snapshot of market participants' initial reactions forms a good basis of evaluating their perceptions at this early stage of the regulatory process. It would be ideal for a later review to be conducted to track market participants' reactions and gauge whether the on-going changes would have delivered any meaningful change in participants' views.

As highlighted earlier in this chapter, there are various conceptions that can be taken to appraise the perceived effectiveness of the EC CRA regulations. So far, this study has highlighted pertinent issues with regards to tenets of good regulation as espoused by Baldwin & Cave (1999) as well as BRTF (1998). There is therefore a need to appraise the EC CRA regulations on these tenets. Further, a theoretical anomaly of regulations being exogenously imposed on regulated entities was highlighted (see for example (Baldwin et al., 2012). This approach, while it may have worked in the past, may encounter resistance among more informed and devolved communities of practice.

This is exacerbated by the fact that industries such as credit ratings are specialist, characterised by high levels of innovation which often mean that regulators may find it difficult to keep abreast of developments in the industry (Armstrong & Sappington, 2007, 2006). In such situations, regulators could fare better if they involve / consult regulated entities and work with them in formulating new regulations. This culminates in a social constitution of regulation, closely aligned to the endogenous regulation theory (see for example Becker, 1985; Ellig, 1991). This study therefore employs the endogenous regulation theory to explore market participants' perceptions of the impact of the EC regulations on the operations of the UK securities market.

3.9 Chapter summary

This chapter offered a review of extant literature in economic regulation, focusing on securities regulation. The review allowed for an evaluation of previous studies that have been conducted in the area, the approaches taken and rationale thereof. Approaches to investigating regulation phenomena were reviewed, ranging from simulated environments holding certain market conditions constant through to comparative studies that look at differences between regulated vs. unregulated environments or pre and post regulation phenomena. State regulation was pitted against its opposite, self-regulation or the use of voluntary codes. Failures in self-regulation or use of voluntary codes were cited as possible triggers for state intervention. Other different drivers of state intervention were evaluated and the possible impact on the resultant regulation discussed. At the core of the chapter were questions on the role of regulation, the type and scope of optimum regulatory approaches as well as how regulations could be judged to be good or not. To that end, Baldwin & Cave (2012)'s tenets of good regulation as well as the BRTF (1998) framework offered a template with five key tenets that could be used to analyse the EC regulations.

At a general level, the economic theory of regulation offers a useful economic perspective of the securities market. It however fails to delve deeper into the behavioural and sociological interplays of the parties involved. This necessitates the employment of an additional theoretical lens to evaluate the issues in this study.

The study notes that despite increasing interest in the broad area of regulation, there have not been many studies investigating the regulation of credit rating agencies in the EU. The recent introduction of the regulations in this area is a developing phenomenon with an agenda that continues to evolve. There is therefore need for better understanding of the regulatory process and the impact on different stakeholders. The next chapter critically reviews extant literature on credit ratings, looking closely at previous studies in the area, theoretical and methodological approaches adopted as well as conclusions drawn. This is meant to help shed light on what has been covered as a way of situating the current regulatory efforts within existing literary conceptions.

Chapter Four:

Literature Review - *Credit Rating Agencies (CRAs)*

4.0 Introduction

This chapter reviews extant literature on credit rating agencies and credit ratings. Previous studies investigating different aspects of credit rating agencies and credit ratings are reviewed to identify theoretical approaches previously adopted, topical and contentious issues covered as well as gaps requiring further investigation identified. The debate on credit rating agencies dating back to their inception in the late 19th century in the United States of America is chronicled to get an understanding of how the current form, focus and revenue model of rating agencies came to be. The next section opens the chapter by giving an overview of previous theoretical approaches taken to investigate credit rating agencies.

4.1 Previous theoretical perspectives on credit rating agencies

Studies carried out in the area of credit ratings previously adopted various approaches in an attempt to better explain dynamics in the credit rating market. Among the most common views were the agency theory view and the reputational capital view (Bunjevac, 2009; Mathis, McAndrews, & Rochet, 2009). The agency and reputational views focused primarily on the conflicts of interests in the relationship between CRAs (as agents) and their principals such as issuers. The sections below discuss some of the topical views explored in previous CRA studies under these two theoretical perspectives.

4.1.1 The agency view of credit rating agencies

The principal agency theory seeks to explain "social relationships of acting for" (Mitnick, 1982, p.442). Specifically, it models the relationships between principals and those contracted to act on their behalf, arguing that the diverging motives and interests result in misalignment of goals between the two groups. At the core of relationships between players in the credit rating market, CRAs were identified as agents acting not in the interests of their principals, but their own (Kerwer, 2005a). This, it was argued, emanated from the conflicted role of rating the organisations that paid them, for the benefit of investors who had no contractual relationship with CRAs (Dorn, 2011; Ponce, 2011). While this view added credence to the diverse motives of players seeking different outcomes in the credit ratings market, it was rather simplistic, ignoring other fundamental considerations of influences broader than just agency motives (Smith & Walter, 2001).

Despite the weaknesses of the principal-agency theory, recent debacles in the EU sovereign debt crisis have helped add weight to this point (Hill & Faff, 2010). It would appear though that the furore over the downgrading of various European countries' ratings no longer centred on agency relationships per se, but also looked at much deeper constructs of the global credit ratings architecture (Mink & De Haan, 2012; Yang & Lei, 2012).

To address the agency problems, regulators proposed additional disclosure and monitoring mechanisms by external entities (Darbellay & Partnoy, 2012). The agents possessed more detailed knowledge than their minders and thus made it difficult for regulators to grasp fully what was happening in the market (Ho, Palacios, & Stoll, 2012). This became dangerous as it could lead to regulatory capture, where the regulators could be subsumed by the regulated entities as they lacked the competence to critically challenge them (Dorn, 2010). So any additional disclosure demanded by regulators would not have served the intended purpose if no one among the regulators competently scrutinised the disclosed information to pick out any irregularities. Further, there was a risk of too much disclosure which could overwhelm regulators possibly already faced with resource constraints (Heflin, Shaw, & Wild, 2011). In the above context, the agency view is therefore simplistic and does not help adequately tease out the complex relationships and influences in the credit rating market.

4.1.2 The reputational capital view of credit rating agencies

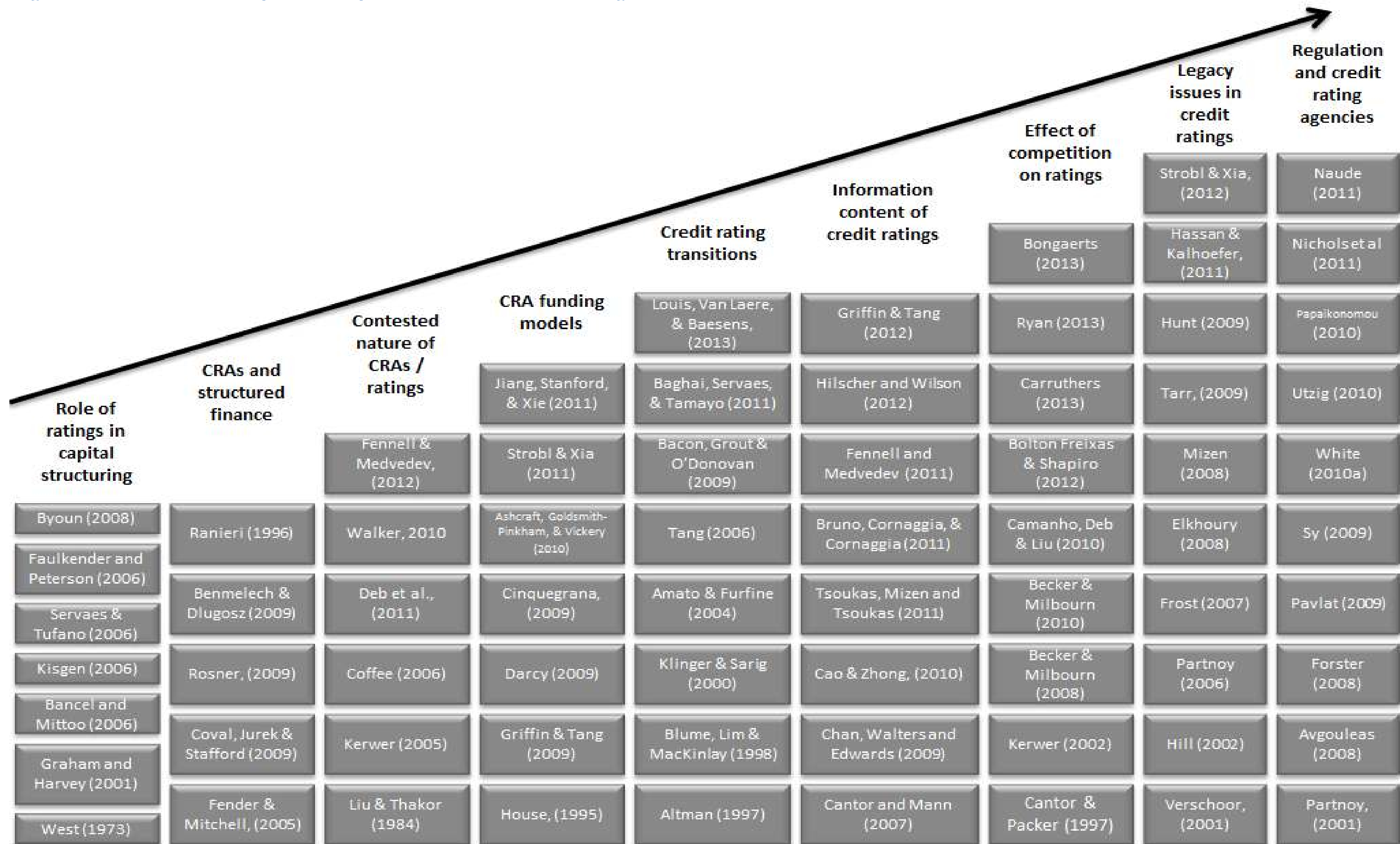
This view asserted that based on consistently delivering reliable rating services, CRAs got to be relied upon and eventually gained the trust of various credit rating users thus building a credible reputation (Covitz & Harrison, 2003; Partnoy, 1999). Consequently, the reputational capital view argued that it was in the rating agencies' interest to maintain highly professional and high quality rating services in order to retain the trust of ratings users. Such a view therefore dismissed the prevalence and significance of conflicts of interest within CRA models, arguing that CRAs' reputations in the industry were far more valuable than winning short-term favours from one issuer (Diamond, 1989). Continued success of a rating agency was therefore closely linked to its reputation and credibility in the market.

The reputational capital view was however contested by Hunt (2009) who argued that CRAs only had reputational capital in old issuances where they had a track record of previous performance. Consequently, when they rated new issuances, they had neither experience nor previous credit ratings in these new products to compare against and therefore would tend to rate regardless of the possible outcomes. Commenting on the same subject in Australia, Bunjevac (2009) concluded that the reputational capital was not a sufficient incentive to address the operational deficiencies inherent in CRA business models, necessitating regulatory intervention. The agency view and the reputational capital perspectives dominated most investigations around credit ratings. As discussed, they both have loopholes, necessitating consideration of alternative views.

4.2 Related previous research on credit rating agencies

As a way of providing a structured critique of the arguments in the extant credit rating literature, the following sections provide a review of previous studies in the area of credit ratings, focusing particularly on topical themes that have been the centre of academic debates. Figure 5 below offers a brickwork visualisation summarising a selection of the main empirical studies investigating credit rating issues, together with the key themes therein. The brickwork shows that the debates on CRAs have come in bursts of themes such as the role of credit ratings on capital structuring; credit ratings and structured finance; the contested nature and conception of credit rating agencies; the informational value of credit ratings (Amato & Furfine, 2004; Cantor & Mann, 2007; Hilscher & Wilson, 2009); CRA funding models and inherent conflicts of interest (Deb & Murphy, 2009; Fennell & Medvedev, 2012; Griffin & Tang, 2009); ratings quality and rating transitions (Duff & Einig, 2009a; Ponce, 2011); legacy problems in the credit rating industry (Posner, 2010), as well as issues around the regulation of credit rating agencies (Avgouleas, 2009; Nichols et al., 2011). The ensuing sections therefore unpick each of these themes, critically evaluating implications for the regulation of credit rating agencies in the European Union. Despite the above varied debates, the role of credit ratings, particularly in capital structuring became even more entrenched (see for example Byoun, 2008; Graham & Harvey, 2001; West, 1973). Figure 5 summarises the differently themed debates on CRAs and their ratings.

Figure 5: Overview of selected previous empirical studies in the credit ratings area



Source: Compiled by author

4.2.1 The role of credit ratings in capital structuring decisions

One area that most scholars seemingly agreed on was the fact that credit ratings have been embedded into the global capital market architecture *(see Table 2 for examples of hard coding of ratings into investment decision-making)*. Table 7 below summarises some selected studies which empirically investigated the importance of credit ratings in global capital markets. The studies highlighted the fact that despite increasing concerns on the role of credit ratings and their efficacy in global securities (see for example Hill, 2002, 2010), they nevertheless remained the cog that drove the functioning of investment decision-making.

Table 7: Empirical studies investigating the importance of credit ratings in capital structuring

Author(s)	Study	Main Findings
West (1973)	Analysed regression data originally produced by Fisher (1959) to investigate the relationship between ratings and yields	Concluded from empirical findings that bond ratings were correlated to yields but largely attributed the relationship to financial regulation
Graham and Harvey (2001)	Used a survey to gauge the perceptions of 392 US-based CFOs on the importance of credit ratings.	When making capital structuring decisions, credit ratings were ranked as the second most important consideration after financial stability
Bancel and Mittoo (2004)	In a study covering 87 companies across 16 countries in Europe, the study sought to investigate the importance of ratings	Their study ranked financial stability as the first most important consideration, followed by credit ratings. Results thus corroborated those of Graham and Harvey (2001)
Kisgen (2006)	Reviewed literary evidence to determine the role of credit ratings in capital markets	Concluded that credit ratings were central to the functioning of capital structuring decisions. The study only looked at firms with ratings, so the reverse may not hold true.
Servaes and Tufano (2006)	Surveyed executives from 344 firms across the globe to determine the significance of ratings in capital structuring decisions	57% of the respondents ranked credit ratings as the most important determinant of debt levels thus corroborating findings discussed in the studies above
Faulkender and Peterson (2006)	Carried out a comparative study of US-based non-financial firms with ratings, vs. those without ratings between 1986 to 2000	The study results indicated a 35% leveraging head-start for rated firms compared to their counterparts without ratings
Byoun (2008)	Investigated the effect of ratings on leverage for different sized firms	Concluded that leveraging and ratings followed a U-relationship with unrated firms having low leveraging which grew as they accessed the ratings market. At maturity, firms with good ratings tended to be choosy about leveraging, relying more on internal financing and only accessing favourable debt.

Source: compiled by author

West (1973) sought to find out whether bond ratings influenced yields and if so, why. The study concluded that ratings were key in predicting yield and maturity in a much more informative way compared to any other publicly available information at the time.

Further, the study concluded that credit ratings directly influenced yields and this was hypothesised to be a likely result of financial regulation entrenching CRAs as a yardstick for viability. There was lack of clarity though on what this supposed causal link was specifically based on. This suggested that perhaps the study could have shed more light on the study parameters. This study was carried out prior to the SEC's 1975 NRSRO designation which further cemented ratings as part of regulatory guidelines on investments and minimum capital requirements and demonstrated that even before the regulatory endorsement of CRAs, ratings were already a key measure of viability in securities issues.

In their study Graham & Harvey (2001) concluded that credit ratings were ranked by the surveyed CFOs as the second most influential variable to be considered when structuring capital deals. This view was held by well over 57% of those surveyed. In comparison to other theoretical variables such as tax advantage, credit ratings received the highest acclaim of factors driving structuring decisions, a testimony to the reliance placed on credit ratings by the surveyed company CFOs.

Bancel & Mittoo (2004) surveyed 87 firms across 16 European countries seeking to establish the importance of credit ratings in financial markets. Their findings placed credit ratings as the second most important factor, after financial stability with over 73% of surveyed participants ranking credit ratings either as very important or important. The study corroborated the earlier findings of Graham & Harvey (2001), demonstrating the perceived universal role of credit ratings in global securities markets.

Kisgen (2006) further corroborated the view above, affirming the entrenched role that credit ratings played in capital structuring decisions in US companies. Kisgen (2006) went further to argue that perhaps the powerful role of CRAs in capital structuring was driven by managerial fears of regulatory pressures that were themselves hinged on credit ratings. In a further study, Servaes & Tufano (2006) carried out a survey on 344 global executives, seeking to determine the significance of ratings on debt capital structures, 57% of the respondents agreed that credit ratings were the most important consideration when deciding debt levels.

On the question why some firms did not use debt, again about 60% of the respondents highlighted the effect of credit ratings. One criticism of this study though was the synonymous use of credit ratings for the level of credit ratings which can confuse interpretation of the study findings.

Faulkender & Petersen (2006) compared firms with rated bonds against those without ratings between 1986 and 2000. They concluded that firms with access to publicly rated bonds had a 35% leverage in comparison to their unrated counterparts. The comparative nature of the study gave it a slightly more balanced view compared to Kisgen (2006)'s earlier study discussed above. The study therefore further underscored the importance of ratings by linking them to firm performance. One slight oversight in the study was that there were no control environments to ensure that the results were not prone to other influences.

Finally, Byoun (2008) investigated the effect of ratings on leverage and found an inverted U-relationship between the two. His conclusion was that smaller unrated firms tended to be lowly-leveraged, as their access to debt markets was restricted. As they grew and slowly got into the credit ratings game, their leveraging grew as they issued debt, accessing more widespread sources of debt funding. Large corporations with good credit ratings tended to have more leverage, choosing more favourable debt as a way of enhancing their financial stability. Access to debt (and consequently, credit ratings) therefore has implications for firms' abilities to secure funding for expansion and other purposes, impacting competitiveness.

The conclusion from the above studies is that credit ratings act as the gateway into accessing debt financing for corporate borrowers. Smaller firms that are relatively new and unknown may not have access to broader debt financing sources and may be lowly-leveraged. There seems to be a strong symbiotic relationship between credit ratings and capital structuring decisions. The inclusion of regulation into the relationship between credit ratings and capital markets would later be one of the key criticism regarding causes of the 2007-8 global financial crisis. The modern financial architecture has evolved around credit ratings and the current regulatory initiatives pose a big change to the way markets have worked for a long time, calling for due process in carrying out impact analyses and evaluating the potential

regulatory impact (Hunt, 2009a). One of the key objectives of the EC regulations was to reduce regulatory over-reliance on credit ratings. If the above studies still hold true, it is difficult to envisage what CFOs, regulators and others will use in place of credit ratings. The objective of reducing reliance on ratings therefore needs to take into consideration practical alternatives that can replace ratings, otherwise the objective may need to be refined in view of the entrenched position of credit ratings in the modern securities architecture (Langohr & Langohr, 2008). Reducing regulatory reliance on credit ratings may not be as simple as it sounds, but may require a significant overhaul of the modern day financial architecture, with far-reaching implications.

4.2.2 Credit rating agencies and structured finance

Arguably, CRAs previously performed consistently well in traditional corporate and bond ratings (Scalet & Kelly, 2012). Evidence suggests that by venturing into the less-well known area of structured financial products, CRAs may have overstretched their resources and went beyond their expertise, resulting in their dismal performance in this area (Rosner, 2009). From the similar symbols and approaches used in rating both structured and unstructured securities products, it can be inferred that there was comparability in risk levels. In reality, nothing could be further from the truth. The vastly different underlying asset structures meant that these were very different areas that needed close scrutiny. Table 8 below highlights some of the pertinent studies investigating ratings in structured securities.

Table 8: Credit ratings and structured finance

Author	Study	Main Findings
Ranieri (1996)	Sought to explain the origins of structured finance products	Concluded that questions around thrift and mortgage provisions in the 1980s were instrumental in fuelling the growth of structuring
Benmelech and Dlugosz (2009)	Sought to explain the role of structured finance in the 2007-8 crisis by making a comparative study of Moody's structured finance ratings vs. corporate bond ratings since 1983	Using findings from 3912 tranches of Collateral Loan Obligations (CLOs), the authors investigated the rating practices in this area. Conclusions highlighted the innovative nature of structuring which brought about in new clientele and additional revenue streams
Rosner, (2009)	Conceptual paper tracing the history of structuring to locate the origins and impact.	Concluded that the nature of structuring incorporated what would otherwise be termed risky asset classes but used similar rating symbols thereby confusing comparability of risk assessments across structured and unstructured products.

Source: Compiled by author

By 2008, there were in excess of 111,988 structured tranches, making this the world's biggest market in the global financial sector (Benmelech & Dlugosz, 2009). The burgeoning growth of structured finance products without the corresponding investment in resourcing and skills may have overtaken the market and resulted in the catastrophic failures that led to the 2007-8 crisis. Ironically, regulators were complicit in the growth of this shaky business model as there is no evidence that they did anything to stop it or question the underlying models (Engel & McCoy, 2011). Instead, touting the age old agency model, focus was still on the agency role of credit rating agencies.

4.2.3 The contested nature of credit rating agencies and their role

To evaluate the perceived impact of CRAs, it is important to define their functional role and examine the implications of their role as well as underlying expectations that come with the role. While there is a common view on the role of credit ratings in global securities markets (CESR, 2008; Heflin, Shaw, & Wild, 2011; Opp, Opp, & Harris, 2012; Richardson & White, 2009; Smith & Walter, 2001), the role and mandate of credit rating agencies is contested with various conceptions of their role being debated. This has ramifications on how the CRAs see themselves and their role versus what the market views them as. The definition of CRAs thus embodies expectations that various stakeholders carry and any conflicts therein may denote polarised real life views on CRAs and may not be helpful for the industry. A different understanding of the role of CRAs by different parties suggests that different stakeholders may have conflicting expectations of CRAs which may need to be reconciled if an objective assessment of their function in the market is to be made.

CRAs have been labelled as gate keepers (Coffee, 2006; Fennell & Medvedev, 2012); proxies for other agencies (Liu & Thakor, 1984); information intermediaries (Fennell & Medvedev, 2012); risk brokers (Walker, 2010); certifiers of credit quality in financial contracts (Deb et al., 2011); and non-Majoritarian Regulators (Kerwer, 2005b) among other labels. These different conceptions of the same entity suggest that there is no consistent acceptable understanding of the role of CRAs. This is an issue that needs to be clarified if the contribution of CRAs to the 2007-8 crisis is to be objectively evaluated.

A selection of studies on the varied conception of CRA roles is presented on Table 9 and discussed in more detail in the ensuing sections.

Table 9: Studies investigating the nature, role and mandate of credit rating agencies

Author	Study	Main Findings
Coffee (2002)	Reviewed empirical evidence defining CRAs as gatekeepers following the collapse of Enron	As gatekeepers, CRAs were said to have had a responsibility to sanction the flow of information and stop wrongdoing. On the contrary, evidence suggested that they failed to do this. Questions arose on possible causes of the failure.
Kerwer (2005)	Conceptualised CRAs as Non-Majoritarian Regulators, empowered with regulatory authority for efficacy reasons	The study concluded that there was an increasing shift of regulatory power from elected institutions to private, profit-oriented Non-Majoritarian actors such as CRAs who however posed challenges on maintaining the democracy-efficacy balance since they themselves were not elected.
Partnoy (2009)	Noted the paradox of increased ratings use on one hand and the declining informational value of such ratings on the other hand	Concluded that CRAs had successfully entrenched themselves as certification agents in a market fraught with information asymmetries and disintermediation.
Walker (2010)	Investigated the CRA role of broking information between different parties and argued that as brokers, they had a duty to make sense of what they were broking	After examining how CRAs operated broking information between issuers and investors, he concluded that CRAs failed their information broking role by not exercising enough due diligence on information being passed to them by issuers.

Source: Compiled by author

The above studies conceptualised CRAs in metaphoric terms, connoting very vivid images of CRAs in their various guises. Of particular note was the conception of CRAs as gatekeepers which appears in this thesis under several sections and was later picked up in more depth in the data analysis and findings section of this thesis. In interviews carried out as part of this study, CRAs argued that they were not gatekeepers, while the rest of the market thought they were. This raised questions on whether the disputed role definition was just a semantic issue or if it symbolised something much more enduring. Coffee (2002) argued that as an example of CRAs as gatekeepers, they failed to play their role leading to the collapse of Enron and should have accepted the blame. The argument was that CRAs held information (or should have) that would have signified to investors the impending changes in Enron's ability to meet its debt obligations. If the alarm had been sounded early enough as was expected, this would have given investors ample time to make decisions about their investments. On the contrary, CRAs were too slow to act, resulting in investors losing their money when Enron collapsed.

Kerwer (2005a) made a compelling argument of private, unelected actors increasingly playing regulatory roles, raising questions of their legitimacy and mandate. He termed these 'Non-Majoritarian Regulators', owing to the lack of backing from the electorates. Despite this lack of electoral legitimacy, he observed that such Non-Majoritarian regulators increasingly became more entrenched in remits that had previously been the preserve of elected governments. Quasi-regulators such as CRAs who operated on a "for-profit" basis posed challenges of balancing democratic issues and efficacy, combined with concerns of possible conflicts of interest where profit was concerned. Further, CRAs lacked the coercive power to compel market participants to comply, yet their ratings carried that compelling force bestowed on them by regulatory formations such as the SEC, BASEL II among others (Carruthers, 2013). CRAs thus presented a shifting form of quasi-regulators which was difficult to pin down as they were not accountable to the electorates. They did not have power directly, yet by virtue of their ratings which were used by regulators worldwide, they had derived power. This ambiguity made it rather difficult for blame on the inappropriate reliance on ratings to be levelled against CRAs themselves, yet they played a key part in this. Walker (2010, p.18) posited that CRAs were an "independent, intermediate, third-party, risk information communicator" opening trade channels by availing risk information to concerned parties. Naturally, if this information was to be of any value, it ought to have been verified to ensure it enhanced the decision-making of the recipients. CRAs therefore failed to verify the information they communicated.

The alleged CRA failures here related to failure to communicate accurate rating updates to investors and regulators as well as failing to verify some of the information CRAs received from issuers resulting in inaccurate ratings and / or rating adjustments. Further, there was a failure to carry out this task in a timely manner. It was alleged that the failure by CRAs to play their risk-broking role could be due to their conflicted interests as they were paid by the same issuers that they were supposed to rate (Pagano, 2010). The role of CRAs as brokers therefore suggests that they were, and are culpable for their part in contributing to the 2007-8 financial crisis and should be held liable for the failures to perform fully as was expected.

The above view is in contrast to how CRAs regard themselves as selling journalistic opinions protected by the First Amendment in the USA (Nagy et al., 2009). This view absolves CRAs of any wrongdoing and unsurprisingly seemed to be their favourite view as it suggested minimal liability for their alleged failures. The conclusion from the analysis of the various conceptions of the role of CRAs and their mandates suggests that there are various possible stances that can be taken in analysing the function of CRAs. This is partly because of the lack of a clearly articulated calibration of the NRSRO role and its key tenets (White, 2001). With new regulations coming in, it may well be that very clear demarcations will need to be drawn making it easier to neatly define and calibrate the continued role of CRAs in securities markets at least in the EU.

Until then, there is need to do further research to scope out the exact role of CRAs and what they should be held accountable for. For CRAs themselves, it is very convenient to be perceived as innocent information conduits that perceivably did not change the contents of their ratings and therefore simply played a messenger role (Darbellay & Partnoy, 2012). Investors and issuers however saw and continue to see CRAs as playing an information broking role which involves transforming the input, synthesising and distilling it to give out modified, updated interpretations of default risk (White, 2010a). Logic would suggest that this was what the market rewarded CRAs for, as opposed to merely posing as empty information vessels. There was and still is a skill required to issue ratings and it is this skill that CRAs claimed to provide and should take responsibility for. The argument here is that CRAs failed to provide a service that they were being paid for. They did not deliver to the expected standard.

4.3 Implications of the definition and role of credit rating agencies

As discussed above, the label that CRAs go by defines their roles and has implications for the responsibilities, accountability, obligations as well as expectations of CRAs by their different stakeholders. This has connotations of relationships between CRAs and other market participants. The sections below briefly explore some of these implications.

4.3.1 CRAs as suppliers of journalistic opinions

Traditionally, CRAs were protected in the US under the First Amendment (Nagy et al., 2009). This protection granted them a journalistic status, allowing them to issue opinions on matters of public interest without any litigation implications if the opinions turned out to be inaccurate. This view of CRAs granted them freedom of speech like any other US citizen and implied that regulation in their activities would be tantamount to interference (Joynt, 2002). It was ironic that such an argument could even be entertained, considering that unlike ordinary opinions, CRAs' opinions were commercial in nature, paid for and should have been governed by laws applicable to commercial contracts not private citizens' first amendment rights (Nagy et al., 2009). Nonetheless, CRAs managed to evade any form of litigious action in respect of their ratings. Regulation 1060/2009 sought to overturn this, in the EU at least and engender an accountability approach in the issuance of ratings (Amtenbrink & De Haan, 2011). It is possible that the lack of legal accountability for their ratings may have caused complacency among CRAs (Partnoy, 2010).

The above argument has to be balanced with the reputational risk view of issuing inaccurate ratings in such an oligopolistic market where reputational damage could ensue resulting in the loss of further rating business (Hunt, 2009a). It is understandable that CRAs argued (and continue to) that their reputations far outweighed any possible litigation risks.

4.3.2 CRAs as quasi regulatory agents

CRAs give opinions which act as licences, granting issuers access to some regulatory privileges (Partnoy, 2006). The strict NRSRO designation by the SEC meant that only the approved rating agencies could issue ratings used for regulatory purposes. This imposed barriers to entry for any would-be new credit rating agencies and entrenched the positions of the incumbent top three CRAs within the regulation of the securities system (Fennell & Medvedev, 2012; White, 2010b). This was particularly so in the 1933 Securities Act, a year later, the 1934 Securities Exchange Act and subsequently, the 1940 Investment Company Act.

The global market has seen increasing dependence by both corporations and governments on foreign debt (Staikouras, 2012). Alongside debt, comes credit ratings, which act as the conduit through which the cost of debt is calculated (Elyasiani, Jia, & Mao, 2010). This places both corporations and governments at the mercy of CRAs and gives the latter significant powers to make recommendations for possible policy or governance changes (Datz, 2004). Various sovereign and corporate bond rating debacles in this area could be viewed as evidence of problems that needed to be addressed, particularly as CRAs were (and still are) privately-run corporate entities seeking profits and yet their ratings have the impact to destroy nations and corporations alike (Scalet & Kelly, 2012). To change this, regulators have to make fundamental changes to the global financial architecture, a feat that will need a gradual shift rather than a 'big bang' approach.

4.3.3 CRAs as gatekeepers

CRAs like auditors, investment analysts and proxy advisors act as gatekeepers by collecting and processing information, playing analysis, verification and interpretation roles (Coffee, 2002). By acting as arbiters in securities markets, CRAs fit the profile of a gatekeeper, defined as a "professional who is positioned so as to be able to prevent wrongdoing by withholding necessary cooperation or consent" (Lombard, 2008, p.2).

Auditors verify disclosures and ascertain whether disclosed information is true and fair (Colbert & Jahera, 2011). CRAs on the other hand make a judgement on the probability of default but like auditors, have to verify and challenge the given information to ensure that the resultant opinion is sound (Fennell & Medvedev, 2012). Auditors, CRAs and analysts tend to be paid by issuers, while proxy advisors are commissioned and paid by the investors. Proxy advisors are therefore slightly different in the sense that they deal with public information which may already have been verified (Löhn & Schwarz, 2013). The target market for proxy advisors is limited to investors while the others tend to have a broader market. While there are minor differences between the above, there is a large area of commonality, suggesting that CRAs like auditors and analysts, have an obligation to verify the information passed on to them before they give out an opinion.

This is contrary to the argument that their opinions are similar to those of any private citizens (in the US), expressing their freedom of speech as citizens do not tend to be required to verify their opinions and neither do they get paid for such opinions (see for example Nagy, Epstein, Martin, Magliocca, & Zinsmaster, 2009). The CRA opinion is therefore not a private citizen's freedom of speech, but rather, a solicited and paid for commercial service that should be covered by commercial contracts. To that end, evidence suggests that CRAs failed to play their role effectively and that regulatory attempts in this regard may be justifiable.

Coffee (2002, 2006) argued that CRAs played a gate-keeping role which was not dissimilar to that of analysts. While CRAs provided debt certification services (Kuhner, 2001), equities analysts focused on equity. As issuers sought higher ratings in order to attract investors, it was not inconceivable that they would present their issues in an inflated way, maybe overstating the attractiveness of their issues. Investors on the other hand (particularly smaller, unsophisticated ones) often did not have sufficient skills and resources to carry out detailed internal due diligence and differentiate between overstated issuer claims vs. genuine ones (Caprio, Demirgüç-Kunt, & Kane, 2010; Fennell & Medvedev, 2012). Investors therefore relied on CRAs to provide unbiased information on issues so as to enhance their investment decisions. CRAs thus provided a cost-effective service (Fennell & Medvedev, 2012) to this end. Failure to provide investors with timely and accurate ratings in this regard then seriously undermined the role of CRAs as gatekeepers.

A gatekeeper according to Kraakman (1986) is a professional whose role enables them to prevent wrongdoing by sanctioning the flow of information, sounding an alarm or withholding necessary cooperation or consent to the offending party. From this viewpoint, investors and the market at large expected CRAs to issue timely initial ratings and subsequently follow them up by providing a monitoring function, issuing upgrades and downgrades where this was necessary. By being slow to perform this function, CRAs failed investors and the market.

Partnoy (2006) argued that the reliance on ratings by regulators made CRAs different from other gatekeepers as this placed them in a quasi-regulatory role, claiming a much higher profile in the securities realm than mere gatekeepers. Further, while other gatekeepers faced civil liability against malfeasance, CRAs were traditionally immune to any form of liability arising out of incorrect rating opinions due to their First Amendment protection (Nagy et al., 2009; Partnoy, 2006). CRAs as gatekeepers therefore failed to prevent wrongdoing by being slow to provide rating transitions and by failing to indicate accurately where there were potential problems (Lombard, 2008). This rendered them significantly culpable for the crisis in 2007-8 among other corporate collapses. Questions still remain on whether this was incompetence or complicity. To help shed light on these questions, it is helpful to consider the other labels that have been bestowed on CRAs as discussed below.

4.3.4 CRAs as information intermediaries

Various authors (see for example Nagano, 2008; Stiglitz, 2009) suggested that as information intermediaries, CRAs were, and should not be held liable for the information they transmitted. This view implied that CRAs simply relayed messages to investors and the market in general on behalf of issuers. Rather, this view placed blame on issuers (for possibly giving out inaccurate information to CRAs) and investors for failing to sense-check the information received in the form of ratings. Unsurprisingly, CRAs themselves favoured this view as it absolved them of any responsibility on ratings quality and accuracy. As if in direct opposition to the above view, Desai, Rajgopal, & Yu (2012) classed CRAs (alongside short sellers, sell-side equity analysts and auditors) as information intermediaries who were all positioned to spot the warning signals in financial statements of leading banks and sound the alarm, a task which they all allegedly failed to perform. Judging from the role that CRAs are paid to perform, the title of information intermediaries seems to fit although this is disputed by CRAs. CRAs were paid to provide expert opinions and marketed themselves on previous track record and skilled analysts, thereby insinuating that they were competent in providing rating services. If this turned out to be untrue, then they should be held liable.

4.4 Financial disintermediation as a catalyst for CRA prominence

As capital markets became more complex, traditional intermediaries were seemingly replaced (Steeman, 2002). This disintermediation caused information asymmetries which further entrenched CRAs as the new cost-effective intermediaries (Cantor & Packer, 1995). The same process that had catapulted CRAs into prominence through disintermediation would arguably later be a catalyst for their downfall as well. The replacement of traditional intermediaries meant that when the system creaked, there was not enough support to stabilise it, leading to numerous concerns of a weakening modern capital market structures (Sinclair & Rethel, 2008). Another hotly debated issue concerning ratings is the contribution of the issuer-pays business model to ratings inflation and the associated conflicts of interest that arise from the supposedly compromised position of rating agencies (Covitz & Harrison, 2003; Strier, 2008). Ratings inflation refers to over-optimistic or inflated ratings which do not accurately reflect the rated entities in reality (Strobl & Xia, 2012). The next set of studies sought to establish if there was a correlation between the issuer-pays model and ratings inflation, an issue that was said to be grounded on the tenets of the agency theory as highlighted in the work of Jensen and Meckling (1976).

4.4.1 Correlation between the issuer-pays business model and ratings inflation

Despite claims that the reputational value and integrity of CRAs engendered objectivity and rating independence (House, 1995), there were incessant criticisms against CRAs regarding the fallibility of the issuer-pays model and its effect on possibly fuelling ratings inflation (Cinquegrana, 2009; Darcy, 2009). This was said to have had the potential to bias rating outcomes due to incentives therein. Several studies have investigated this and a selection of those carried out after the 2007-8 financial crisis is given in Table 10 below and subsequently discussed in the ensuing sections.

Table 10: Empirical studies - correlation between the issuer-pays model and ratings inflation

Author(s)	Study	Main Findings
Griffin and Tang (2009)	Studied CDO issuances between 1997 and 2007 to determine the level of subjectivity in ratings methodologies	Observed an average increase of 12% on AAA tranches. The authors noted a 25% correlation in judgements between the model and the AAA outcomes, suggesting that the rest of the attributes were subjective
Deb and Murphy (2009)	Empirically reviewed evidence on the prevalence of conflict of interest issues in the issuer-pays model	Concluded that the issuer-pays model can never be made to work without conflicts and inherent risks. Proposed rather a return to the investor-pays model to align the interests of CRAs with consumers of ratings
Ashcraft, Goldsmith-Pinkham, and Vickery (2010)	Using time series trends, studied subprime and Alt-A residential MBS issuances between 2001 and 2007 representing 90% issues in this period comprising (60,000 securities and 12.1million loans)	Noted a decline in the standard of rating in the MBOs between 2005 and 2007, particularly leading up to the crisis. They concluded that as volumes of MBS issuances rose, the quality of ratings fell, possibly owing to higher risks of possible default but also because there were more issuances competing for the few agencies
Strobl & Xia (2011)	Compared ratings between 1999-2009 issued under the issuer-pays model vs. the investor-pays model and ruled that the issuer-pays model led to inflated ratings	The exclusive comparison of issuer-pays vs. investor-pays model eliminated other noises such as market influences to be able to conclude that indeed, the issuer-pays model tended to favour issuer desires for higher ratings
Jiang, Stanford, and Xie (2011)	Investigated S&P rating changes around the adoption of the issuer-pays model by analysing historical rating data from 1971 to 1978	By using Moody's data as a benchmark for the same period, the study concluded that indeed after the adoption of the issuer-pays model, S&P ratings became more optimistic, possibly as a competitive attempt to win more issuing business.
Strahan (2011)	Carried out a comparative study of S&P vs. Moody's ratings funded using different models.	Observed unduly high ratings by Moody's and S&P when rating large MBS issuers between 2004 and 2006. This suggested that the two CRAs were more optimistic when rating bigger issuers who promised higher potential revenue streams.
Fennell and Medvedev (2011)	Empirically reviewed literature on CRA business models as well as interviewed 14 participants drawn from CRAs, investors, academics and other trade associations	While concurring that the issuer-pays model was fraught with conflicts, they argued that the investor-pays model on its own would succumb to free rider problems and not survive. They proposed a platform model where CRAs would be centrally allocated ratings via a central public body (platform). They further acknowledged that the regulatory use of ratings exacerbated problems in the market leading to the crisis.

Source: Compiled by author

Griffin & Tang (2009) analysed 916 CDOs from a leading CRA between 1997 and 2007 to try and understand the consistency of the CRA's rating adjustments. Their findings corroborated views on the lack of clarity in the ratings models used in CDO ratings. They highlighted the element of subjectivity inherent in ratings, making it difficult for the market to critique the accuracy of ratings. The authors noted the existence of a deeper correlation between the sophistications in the rating models (contributing to the mystical view of the credit rating process which meant that apart from rating analysts, very few others understood or dared critique the rating methodologies) and the propensity for higher proportions of AAA rated tranches.

While there was no evidence of a direct link between the issuer-pays model and ratings inflation in Griffin and Tang (2009)'s study, the lack of transparency on the rating methodologies suggested that this was not dissimilar to a blank cheque should CRAs want to exploit this rather hazy conceptualisation of credit ratings.

In a later study, Strobl & Xia (2012) compared ratings from S&P issued under the issuer-pays model vs. those issued under the investor-pays model followed by Egan Jones and concluded that when conflicts of interests were heightened at S&P, evidence of ratings inflation was prevalent. In particular, they observed that S&P was more likely to issue a higher rating when the issuer had "a new CEO or CFO; had more short term debts or had a lower percentage of ratings from S&P" (Strobl & Xia 2012, p.1). In any of those highlighted events, stakes would have been high for the rating agency to favourably position itself and win the favour of the issuer, particularly to attract the attention of the new CEO/CFOs. While the findings were localised to S&P versus Egan Jones and could have been influenced by specific contexts surrounding those ratings at the time, this suggested that competitiveness issues potentially played an influencing role on rating decisions.

Jiang, Stanford, & Xie (2012) carried out a study to test whether S&P's ratings changed after they adopted the issuer-pays model. To get a comparative view, the study chose ratings covered by both Moody's and S&P but where Moody's was paid by investors and S&P by issuers. Initially, before the switch to the current issuer-pays model, S&P ratings were generally lower than those of Moody's. After the switch to the issuer-pays model, evidence presented indicated that S&P's ratings crept up to be comparable to those of Moody's. Moreover, the study revealed that S&P's ratings were most likely to be higher where there were greater conflicts of interest as denoted by higher anticipated rating fees and lower rating quality. This finding, although localised to S&P and Moody's was the second confirmation that S&P ratings were amenable to conflicts of interests and that competition may have had a direct link to the quality of ratings.

He, Qian, & Strahan (2011) studied MBO ratings from both S&P and Moody's between 2004 and 2006. They observed that the two CRAs were more inclined to issue higher ratings to larger issuers (who ostensibly represented more significant potential future revenues and higher fees). This finding further confirmed the findings discussed above (Strobl & Xia, 2012; Jiang, Stanford, & Xie, 2012) and suggested that despite attempts to be objective and independent, the nature of CRAs as private, profit-seeking businesses significantly compromised their role as public information arbiters providing objective rating opinions since they had profitability issues to contend with (see also Kerwer, 2005; Lynch, 2008).

It was not inconceivable to see CRAs playing to the tune of the paying issuers particularly in light of the above evidence. This was despite the fact that there were a few players competing in the ratings market. With proposals to increase competition, if the above observations hold true across other CRAs following the issuer-pays model, then competition may not address the identified problems. Instead, it may likely fuel ratings inflation as CRAs seek to competitively attract ratings business. One of the key questions posed to participants in this study therefore sought to gauge their views on how increased competition among CRAs could impact the ratings quality in the ratings industry.

The role of CRAs has largely been viewed from an agency perspective with CRAs' own self-interests perceived to be compromising an objective rating service (Lewis, 1996). While various schools of thought previously considered the implications of the issuer-pays model, the model is still pervasive (Darcy, 2009; Hunt, 2008; White, 2010b). One prominent argument asserted that CRAs are reputational intermediaries (Bonewitz, 2010) and as such, they would strive to maintain accurate ratings (despite the inherent conflicts) if they were monitored through appropriate, enhanced disclosure mechanisms (Horner, 2002; Klein & Leffler, 1981). The inference here is that with dented reputations, CRAs would not be able to survive hence the inherent conflicts of interest would be outweighed by the reputational drive. The argument was therefore that it was in CRAs' own interests to provide an objective, quality rating service, downplaying allegations of conflicted ratings in the market (Hunt, 2009a; Partnoy, 1999).

The reputational argument was however downplayed by (Mathis & McAndrews (2009) and Covitz & Harrison (2003) who made a comparative assessment of the reputational trade-offs and concluded that when the benefits outweighed the costs, reputation would not be a significant enough deterrent. This point was further underscored by Bonewitz (2010) who argued that the fact that CRAs thrived even when their reputations were dented suggested that reputation was not as key to their survival. Fennell & Medvedev (2012) highlighted the effect of the conflicts of interest in compromising trust and credibility of CRAs. They proposed a number of alternative models and in particular, the platform model which proposed the establishment of a central, public body that would act as a reservoir for all rating requests. The central platform would then be responsible for allocating the rating requests (as they came in) to bidding CRAs. The proposal sounded attractive although it still needed certain aspects of it fleshed out in more detail. More details on the platform model are given in section 4.4.1.3. The sections below briefly explore various business models proposed in light of the above studies and comments.

4.4.1.1 The issuer-pays model

The issuer pays model was (and still is) conflicted, with CRAs being paid by the very organisations they rated (Fennell & Medvedev, 2012). This was said to open up possibilities of rate shopping, bias and possible inflated ratings (Skreta & Veldkamp, 2008). In their study of Moody's structured ratings, Benmelech & Dlugosz (2009) concluded that in the majority of cases, structured tranches rated by one CRA were most likely to be subsequently downgraded by a different CRA, suggesting evidence of rate shopping as issuers sought to get the most competitive rating and playing CRAs off each other.

Further, because CRAs often provided other ancillary services such as advisory services, there was an argument that CRAs could in effect be rating the same entities they would have previously helped to structure while providing advisory services (Crockett, 2003). In such cases, it would be difficult for a CRA to put together a structure, then rate it lowly later. Others also argued that CRAs could provide favourable ratings as a way of inducing issuers to do business with them (Pagano & Volpin, 2010).

Despite these shortcomings, the issuer-pays model is still pervasive as it largely works, is viable for CRAs and allows for ratings to be available publicly (Ponce, 2011). So far, this has been touted as the most practical model allowing for an efficient process despite its limitations around issues of conflict of interest.

4.4.1.2 The investor-pays model

Under this model, investors would be paying CRAs for credit ratings. The exact format of the transactions could either be in the form of ad-hoc transactions as and when ratings are required or it could take a subscriptions-based approach (Fennell & Medvedev, 2012). This model suffers from potential free riding, which could potentially be exacerbated by rating leakages. It is not inconceivable that issuers might try and publicise their ratings in a promotional attempt, thus making them available to investors who may not have paid for them. This could dampen investors' appetite to pay for ratings if alternative ratings were freely available. Further, the model does not allow for ratings to be accessible to non-paying subscribers, a feat which may further exacerbate information asymmetry in the market (Schroeter, 2011).

Arguments against this model posit that this is equally prone to conflicts of interest that can potentially arise from investors (Altman, Oncu, Richardson, Schmeits, & White, 2010). This view was disputed by Pagano & Volpin (2008) who asserted that it was unlikely that a diverse group of investors would exert uniform pressure on CRAs. Where ratings were used for regulatory purposes, this model would make it difficult since such ratings would be private. Another challenge was that this model was not practical for new and unknown issuers that investors did not yet know about (Papaikonomou, 2010). New and unknown issuers would find it difficult to have ratings commissioned on them, creating entry barriers for any such new issuers (Bruno, Cornaggia, & Cornaggia, 2011; Cornaggia, 2010).

4.4.1.3 The platform model

The platform model would see CRAs selected through a central and independent vetting process to respond to specific rating bids (Fennell & Medvedev, 2012). The platform model would effectively sever the direct relationship between issuers and CRAs as a way of eliminating the conflicts of interest which potentially distort ratings (Mathis et al., 2009; Pagano & Volpin, 2010).

The platform or central body would charge issuers and use some of the proceeds to commission and pay CRAs, independent of the rating outcome (Mathis et al., 2009). This would ensure an objective process for allocating rating tasks to CRAs. As CRAs would be commissioned by a central public body, there would be no need for them to market themselves directly to issuers thus eliminating the conflicts of interest currently prevalent in the issuer-pays model (Ashcraft, Goldsmith-Pinkham, & Vickery, 2010). The criteria for selecting CRAs could be random, on a rotation basis or even based on track record to encourage competition and drive rating accuracy levels up. While such a form would provide independence of those providing the ratings from the rated, its conception is still embryonic and its viability susceptible to a lot of practicality questions which as yet have not been clarified. Had the Franken Amendment[10] been implemented in the US, it would have seen a platform model being established.

One of the concerns with this model is that there would be yet another new body to be managed, raising questions on who would be best placed to provide that oversight. Further, the proposal makes a simplistic assumption that all CRAs would possess the same skills, competences and jurisdictional presence for a random allocation of rating bids to be possible. In reality, this is not so. CRAs may operate in particular niche areas or geographic locations. This model therefore needs more clarity to address the finer details around its practicality.

[10] The Franken Amendment (Section 939F) was a proposal to eradicate rate shopping by establishing a central function that would allocate rating requests to CRAs, accepting fees from issuers. While in principle it sounded good, it was fraught with several irregularities with regards to implementation.

4.4.1.4 The public model

This model was promoted by scholars like Lynch (2009) and is premised on ratings as public goods and would constitute a publicly-funded rating entity which would make its ratings available publicly (including to investors). Its funding could be drawn from taxpayers, levies on issuers or any other suitable funding mechanism. As the entity would be free from competitive pressures, it is envisaged that this could boost its independence and improve the quality of its ratings. In reality the public model could still be prone to political and other pressures particularly when it comes to sovereign ratings (Fennell & Medvedev, 2012). Its state funding could also pose unfair competition to smaller independent CRAs. Other scholars (see for example Lynch, (2009)) have expressed concern over potential bureaucracies that could impede its ability to attract talent and weaken its effectiveness. Further, budgetary limitations, innovation and other bottlenecks could affect its responsiveness to dynamic rating needs. Despite the above proposal, regulatory coordination remains a problem particularly for issuers issuing across different markets, unless such a CRA was regional e.g. funded by the EU or similar regional or global bodies. While this could alleviate coordination problems, it does not address the issue of allegiance and potential biases (Klöhn, 2010). From this, it would appear that a fee-based approach would offer more promise. The next section goes back to the basics and highlights the problems said to be inherent in the current CRA revenue model.

4.4.2 Alleged problems in the CRA revenue model

For several decades now, scholars and practitioners have been debating various issues inherent in the CRA issuer-pays revenue model (Strobl & Xia, 2012; Kuhner, 2001; Lynch, 2009). The sections below briefly discuss some of the topical legacy problems that prompted calls for regulation.

4.4.2.1 Conflicts of interest

Conflicts of interest exist at multiple levels in the rating industry. The most obvious and commonly cited conflicts were those manifested in the issuer-pays model (Egan, 2009). Whereas the commonly touted agency view posited that because issuers paid CRAs, they could influence the CRAs to issue inflated ratings in a bid for issuers to attract favourable borrowing terms (Darcy, 2009).

On the contrary, the reputational capital view suggested that it was not in the best interests of any CRA to play along to issuer's demands as this would compromise CRAs' long term reputation and ruin future prospects of getting continued ratings business (Covitz & Harrison, 2003). The reputational capital view was premised on the argument that CRAs thrived on their reputation and the more accurate ratings they issued over time, the stronger their reputation among market participants would be, thus increasing future business prospects (Hunt, 2009). It was further argued that to suggest that such a reputation could easily be sacrificed to serve issuers' short-term desires for inflated ratings would be naive (Goodhart, 2009). Further, the choice of which CRA to use was said to be driven largely by regulatory pressures as well as investment mandates / guidelines (Partnoy, 1999). Consequently, Fennell & Medvedev (2012) argued that the management of such conflicts was hinged on competition and reputation.

Reviewing empirical evidence on conflicts of interest, Frost (2007) concluded that CRAs were indeed compromised by their conflicted positions but added that the issuer-pays model was the least costly option when compared to other available alternatives. Whereas Radley & Marrison (2003) argued that CRAs were compromised by virtue of designing different models subsequently used by their rated banks and could not downgrade their own work, Veverka (2003) refuted this claim, arguing that commercial arms of CRAs were heavily insulated and firewalled from the analysis activities. These varied views demonstrate just a few of the polarised arguments regarding the issuer-pays model and its implications for the ratings industry.

Notwithstanding the polarised views regarding the CRA conflicts of interest, it was not inconceivable that CRAs could be swayed by their paymasters. The lack of competition among CRAs suggested that perhaps the issuer-CRA relationship was skewed in favour of CRAs whose reputation was their backbone in this industry. Evidence from empirical studies investigating this suggests that indeed competitiveness issues did affect ratings thus lending validity to claims of conflicts of interest (Jiang et al., 2012; Strobl & Xia, 2012) and impact on ratings quality.

4.4.2.2 *Credit rating transitions*

Another key area covered in previous studies was that of credit rating changes or rating transitions from one rating category to another (see for example Altman, 1998; Altman and Rijken, 2005). Such changes either signified deterioration in the prospects of the rated entity (downgrade) or an upgrade denoting improved outlooks (Altman, 1998). Rating transitions have a significant impact on investment decisions associated with tolerance levels for credit quality, particularly as they also send signals to the market and thus affect share prices (Altman, 1998). At the heart of previous debates involving rating transitions were issues to do with the CRAs' through-the-cycle[11] rating methodologies and implications thereof (Altman & Rijken, 2005). A selection of some of the main empirical studies in this area are summarised in Table 11 and discussed in the ensuing sections.

Table 11: Empirical studies investigating credit rating transitions

Author	Study	Main Findings
Altman (1997)	Compared bond ratings from Moody's and S&P between 1970 and 1996	Concluded that there were differences in methodologies between the two organisations, making direct, 'like-for-like' comparisons difficult
Blume, Lim and MacKinlay (1998)	Investigated rating transitions between 1978 and 2006	Concluded that CRAs had generally become more conservative and issued slightly tampered ratings and that transitions tended to be more forthcoming in the case of upgrades than downgrades
Klinger and Sarig (2000)	Studied market security responses to Moody's rating system refinement in 1982	As Moody's refinement changes only related to methodological alterations of the rating approach, the study concluded that firm value was not driven by rating information, rather, debt value rose or fell whenever Moody's made a rating announcement
Amato and Furfine (2004)	Analysed ratings data between 1984 and 2001	Established strong correlations between credit rating transitions and business / financial risks as opposed to cycle-related issues.
Tang (2006)	Examined Moody's credit rating transitions in 1982 seeking to determine the effect of rating changes	Concluded that rating upgrades generally resulted in lower movements compared to rating downgrades. On average, rating upgrades resulted in a 7 point (0.5%) reduction in costs of debt, while downgrades led to a 13 point (0.7%) increase in the cost of debt.
Bacon, Grout and O'Donovan (2009)	Interviewed 43 UK-based corporate treasurers to gauge views on the effect of the crisis on corporate capitalisation	Results indicated significantly reduced confidence in corporate debt sources. Leverage levels were anticipated to fall significantly as banks further tightened on lending
Baghai, Servaes, & Tamayo, (2011)	Investigated rating transitions between 2005 and 2009 to determine whether CRAs had become more conservative or not	Studied and documented rating transitions and concluded that generally, CRAs had continued to be conservative, issuing tampered ratings that saw A+ dropping by an average 3 notches to BBB+

Source: Compiled by author

[11] *Rating through-the-cycle looks at the performance of a rated entity in the long term, ignoring short-term volatility. This is opposed to a point-in-time rating approach that takes a snapshot of a particular point.*

Blume, Lim, & Mackinlay (1998) argued that generally, the rating regimes across the industry became tougher between the 1980s and early 1990s, suggesting that ratings became stricter as CRAs became more cautious. This finding was in contrast to earlier conclusions by Cantor & Packer (1995) who had observed deteriorating ratings and increased default rates within rating categories. This contradiction was somewhat explained by later studies (Zhou, 2001) as emanating from a slight bias in the Blume et al., (1998) model used to generate the data. In a later study post the financial crisis, Baghai, Servaes, & Tamayo (2011) reported a further escalation of the tightened rating regime, further asserting that A+ ratings had seen an average drop of 3 notches to BBB in observations made in ratings between 1985 and 2009.

Kliger & Sarig (2000) carried out a study around the time Moody's changed their gradation system from the original 9-letter-based rating scheme to the current letter plus numeric qualifier categories with 19 different options. As the change was simply a methodological adjustment to rating category labels, they concluded (unsurprisingly) that there were no changes to firm values. They however went on to observe that whenever Moody's made a rating announcement, issuers' debt values changed up or down. This depended on whether the announcement was positive or negative and raised questions on whether ratings drove the market or vice versa. This study, while significant, did not consider future informational contents of ratings (Gonzalez et al., 2004), and was rather short-term oriented, failing to project the study findings beyond the local context at the time.

Tang (2006) argued that information asymmetry contributed greatly to rating transitions. The study of Moody's credit ratings indicated that third party rating agencies contributed significantly to rating movements as they provided new information which in some cases prompted revisions to existing ratings. This however suggested a potential by CRAs to use such unsolicited ratings to coerce issuers into seeking ratings with them to avoid adverse publicity (Poon, 2003).

Meanwhile, Bacon, Grout, & O'Donovan (2009) observed continued tightening of ratings in UK corporate and bond ratings, a trend that detrimentally impacted access to favourable borrowing terms and restricted borrowing options for some firms.

This finding suggested that despite claims of objectivity and rating accuracy, CRA ratings generally migrated based on market confidence and perceived levels of exposure to risk by CRAs. Questions arose over recent proposals to hold CRAs liable for inaccurate ratings, a move that could further constrain ratings as CRAs would fear reprisals for any inaccurate ratings and become more conservative, sparking a vicious cycle (Partnoy, 2001). Further, the conservative approach to ratings that is reported in the studies above could hamper market operations by tightening the availability of credit and potentially weakening market confidence overall. This further raised questions about the exact nature of ratings, particularly whether the subjective component of the rating was being over-emphasised (Iyengar, 2012; Sinclair, 1994; Partnoy 1999; 2001). While the subjective element allowed for the capturing of incidental environmental factors alongside ratings, its rather hazy nature may be its undoing (White, 2010b). This thread of inquiry therefore raised pertinent questions about both the rating process, the methodologies, accuracy and questions whether CRAs could use ratings as levers projecting their own internal insecurities potentially holding the market at ransom.

4.4.2.3 Informational content of credit ratings

Another key area covered in previous studies concerned the informational content of credit ratings. Table 12 below gives a selection of some of the main empirical studies reviewed in this area:

Table 12: Studies investigating the informational content of credit ratings

Author	Study	Main Findings
Cantor and Mann (2007)	Evaluated the conflicting need for stable ratings on one hand and the need for timely ratings on the other	The study concluded that market requirements of ratings were themselves conflicted in the sense that on one hand, stability was favoured, while on the other, CRAs had to report timely movements, which if they did, would cause market volatility. CRAs could thus take a middle ground approach in determining rating contents. This would be subjective.
Chan, Walters and Edwards (2009)	Carried out a comparative study of information content of subscribing vs. non subscribing CRAs in Australia	Concluded that ratings released by subscription-only CRAs carried value of up to 8 months after the rating compared to those ratings based on publicly available information
Tsoukas, Mizen and Tsoukas (2011)	Analysed US bond ratings issued by Fitch between the periods of 2000 - 2007	Study results questioned the ability of credit ratings to see “through-the-cycle”, and concluded that there was strong correlation in ratings with previous and initial firm states, influencing the rating.

Author	Study	Main Findings
Bruno, Cornaggia, & Cornaggia (2011)	Investigated informational content of ratings from a CRA pre and post its designation as an NRSRO and the impact of the subsequent business model change	Concluded that the investor-pays model yielded better informational value of ratings compared to the model adopted later (issuer-pays)
Hilscher and Wilson (2012)	Investigated the extent to which credit ratings measured the raw probability of default as opposed to systematic risk of default	Their study concluded that credit ratings were poor measures of raw probability of default while on the other hand the same ratings were strong indicators of systematic risk

Source: Compiled by author

Cantor & Mann (2007) explored the tension between the need for timely ratings that were responsive to market changes on one hand and the need to maintain rating stability on the other. They concluded that this conflicted demand tore CRAs apart and forced them to strike a compromise by taking a middle ground approach and rating 'through-the-cycle' rather than responding to flimsy short-term market movements. While this was a plausible compromise, it raised questions on the objectivity of the compromised middle-ground approach (Altman & Rijken, 2005; Mizen & Tsoukas, 2009). For example, this raised such questions as the consistency across CRAs; the level of exposure to investors e.g. in a bid to maintain stability, were CRAs waiting until it was too late before effecting a rating change? This was not a fault on the part of CRAs but was an issue that was imposed by the market on them.

Chan, Walter, & Edwards (2009) attempted to demystify the age-old question around unsolicited ratings based only on publicly available information and concluded that the fact that the alternative gave CRAs access to company management made a huge difference in the informational value of the resultant ratings. Therefore, according to their study, ratings carried crucial informational content (see also Kliger & Sarig, 2000; Krahnen & Weber, 2001).

In a later study, Tsoukas, Mizen, & Tsoukalas (2011) investigated the determinants of credit ratings and their role in 'through-the-cycle' forecasting. They concluded that ratings were enduring and indeed saw through-the-cycle, rather than taking a short-term volatile approach. The study sought to restore confidence in an area that was at the time being severely criticized following the crisis and the authors concurred that ratings still held informational value and did show some consistency even during deeps and peaks.

Bruno, Cornaggia & Cornaggia (2011) investigated ratings from a CRA pre and post its NRSRO designation in 2007 and concluded that while the CRA in question operated under an investor-pays model, the informational content and timeliness of its ratings were higher and fell soon after it adopted an issuer-pays model. This may explain potential effects of incentive mechanisms at play as well as possible conflicts of interest said to be inherent in the issuer-pays model (see also Darcy, 2009).

Hilscher & Wilson (2009)'s investigation on the predictive abilities of credit ratings revealed a puzzling aspect of credit ratings. Despite their dominance as predictive instruments for default, their study revealed inherent weaknesses of failing to distinguish between firms (by assigning them a similar risk score when in fact they bore different underlying asset structures). Further, ratings were shown to be closely correlated to publicly available information, a characteristic that questioned their predictive ability and portrayed them as lagging. The study also revealed that credit ratings were not good indicators of default variability over time (Atiya, 2001; Elkhoury, 2008).

4.4.2.4 The effect of competition on ratings

Whereas regulators claimed that lack of competition in the ratings market hampered ratings quality and limited choice (see for example Hill, 2004; Hunt, 2009a; Pinto, 2006; Utzig, 2010), some studies carried out to review the effect of competition on ratings suggested otherwise. The following are a selection of some of the studies in question.

Table 13: Studies investigating the effect of competition on ratings

Author	Study	Main Findings
Becker and Milbourn (2008)	Sought to investigate the impact of increased competition on ratings and CRA behaviour, using Fitch's entry into the market	Concluded that with Fitch's entry into the market, S&P ratings rose; correlation between ratings and bond yield deteriorated as ratings peaked as well as equity price volatility in response to downgrades
Bolton Freixas and Shapiro (2010)	Carried out an empirical review of evidence on competition and ratings	Concluded that despite claims by regulators that increased competition would serve the market positively, on the contrary, their study revealed that increased competition would fuel ratings inflation and erode market efficiency
Becker and Milbourn (2010)	In a follow up to their 2008 paper, the authors revisited the topic after the crisis and arrived at similar conclusions as in their previous study.	Concluded that more competition had a detrimental effect on ratings quality. They particularly noted that the entry of Fitch resulted in inflated ratings from Moody's and S&P. There were concerns that the EC regulations could deliver undesirable competitive effects in the market and further fuel ratings inflation.
Camanho, Deb and Liu (2010)	Compared duopolistic and monopolist scenarios to investigate the trade-off between reputation and fees in increased competition contexts	Concluded that CRAs succumbed to competitive pressures and that this was reflected in ratings inflation.

Source: Compiled by author

Scholars have argued that increasing competition among rating agencies may not address market ills but instead fuel rating inflation as CRAs rate favourably to win business against their competitive rivals (Becker & Milbourn, 2009; Bolton, Freixas, & Shapiro, 2012). This view was consistent with Camanho, Deb, & Liu (2010)'s findings. They argued that with increased competition, CRAs tended to rate more favourably compared to less competitive situations. In their study, Bongaerts, Cremers, & Goetzmann (2012) compared ratings across the three CRAs using similar issues in the same quarter. They concluded that on average, Fitch's ratings were more optimistic compared to those from Moody's or S&P. This was consistent with Cantor & Packer (1997)'s findings in an earlier study. As the smallest of the three CRAs fighting to assert itself in a competitive market where it held a smaller share, Fitch was deemed to be the most positive, out of the three. This raised a question on whether favourable ratings could be used for competitiveness and if so, what the effect of more competition would be if the EC regulations managed to increase competition among CRAs.

The implication of these findings is significant for the EC regulations and suggests that regulatory aims of increasing competition may be sound when viewed from a general marketing competition point of view, but that the credit rating industry is a peculiar one where general laws of competition may not work well. The regulatory objectives with regards to competition therefore need reviewing to ensure that the correlations between competition and ratings inflation are carefully measured and results incorporated into regulatory objectives. This would ensure that unintended consequences are minimised in relation to ratings inflation emanating from an influx of competitors.

4.4.3 Legacy issues in credit ratings

The alleged causes of the 2007-2008 global financial crisis in general, and the subsequent contagious turmoil among some European Union member states in particular were said to have been multifaceted, encompassing regulatory shortfalls (Langohr & Langohr, 2008; Tropeano, 2011); perceived governance failures (Johansson, 2010); greed and general moral decay (Dhiman, 2008; Lewis, Kay, Kelso, & Larson, 2010; Othman et al., 2010). A lot of these issues related to allegations of enduring legacy problems in the credit rating agency operating model, which attracted calls for the tighter regulation of credit rating agencies.

In justifying regulatory initiatives, the EC regulators highlighted a number of inherent legacy problems in the CRA revenue model. The sections below briefly discuss some of the individual legacy problems, drawing implications of such problems on the ratings market and how these were linked both to the financial crisis and the calls for regulation of CRAs, particularly in the EU.

4.4.3.1 Conflicts of interest

The issue of CRA conflicts of interest typically arose where CRAs had financial interests in their contractual rating relationships (Frost, 2007). Arguably, it was three-pronged, incorporating firstly, conflicts arising from the issuer-pays model where CRAs got paid not by investors and other consumers of the ratings they produced, but by the very organisations that they rated (Elkhoury, 2008; Tarr, 2009). This may have led to issuers wielding leverage on the agencies and possibly influencing them to produce more favourable ratings.

Where this was not so, it was not inconceivable that issuers could shop around for the agencies that gave them higher ratings thus fuelling rate shopping and consequently, ratings inflation among CRAs as they competed for business (US Permanent Subcommittee on Investigations, 2011). With ratings inflation, ratings provided became meaningless in so far as their use for timely and proactive investment decisions were concerned, (Hunt, 2009a). As discussed above, this raised contentious questions on whether the EC regulatory aim of increasing competition among CRAs could help curb some of the problems identified in the industry if increased competition potentially induced ratings inflation. If the market became a 'buyers' market' it is possible that rating agencies could start aggressively competing on the basis of issuing favourable ratings to win business, thus fuelling rate shopping which could ultimately lead to ratings inflation.

The second source of conflicts arose from the issuing of unsolicited ratings which could have unduly pressured issuers to resort to engaging and paying the agencies in the hope of getting better ratings and thus suggesting that unsolicited ratings may have been used as a lever to coercively corral issuers into doing business with CRAs issuing such unsolicited ratings (Poon, 2003). This view was discounted by scholars who emphasised the reputational capital view of credit rating agencies (see for example Bonewitz, 2010; House, 1995; Mathis et al., 2009).

Viewed from a different angle, unsolicited ratings may actually be a positive, objective opinion by an agency that does not have the alleged blinkers of being commissioned and paid by the rated issuer. One of their downsides was perhaps the lack of detailed inside information and the possible trigger of herding behaviour if the other commissioned agencies tended towards the unsolicited rate to err on the safe side. This could however be addressed through transparent rating methodologies that would clearly outline the assumptions considered in making a rating. The last source of conflicts allegedly arose from CRA advisory roles in helping to structure Collaterized Debt Obligations (CDOs) which they may have later rated (Strobl & Xia, 2012). In such cases, CRAs combined the player / referee roles, raising questions about their objectivity in rating structures they may have earlier helped to create (Hassan & Kalhoefer, 2011; Verschoor, 2001).

Linked to this was the supposedly limited number of sponsors in the structured finance industry, with overall responsibility for a huge number of structured issues in the market. This may have entrenched the power of the limited number of CRAs who may have had to deal with a limited number of sponsors, making it an almost closed market.

The 2003 IOSCO Report of 'Analyst Conflicts of Interest' singled out issues affecting analysts' independence and objectivity emanating from agencies providing ancillary services to the same issuers they rated (Elkhoury, 2008; Tarr, 2009). Other anomalies included notching, which suggested deliberate lowering of rates on those issuers not rated by a particular agency, possibly an arm-twisting nudge to get them to seek ratings from the particular agency. Although the IOSCO code offered some guidelines to mitigate the potential conflicts of interest, these continued to be pervasive as they were said to be ingrained in the issuer-pays rating business model. Until the revenue model changes, CRA conflicts of interests may possibly remain an inherent feature of the CRA revenue model.

One previous suggestion was to change the CRA revenue model to an 'investor-pays' model. As discussed previously, this however would result in a public goods / free rider problem where other non-paying third parties would freely access the ratings, rendering it difficult to corral the benefits and confine them solely to those who pay (Fons, 2008; Rousseau, 2009). If on the other hand, credit ratings were restricted only to those who pay, the market would be starved of ratings information and therefore fail to self-regulate. This would leave a catch-22 situation, suggesting that perhaps for now, the status quo may be the best unless a more viable alternative was found.

A dissenting view was presented in 2008, citing a balance between the issuer-pays and investor-pays models (SIFMA, 2008). The SIFMA Task force concluded that ancillary services themselves were not a bad thing as long as CRAs put in place robust governance structures to mitigate the effects of conflicts of interest within their operations. To corroborate this view, a number of studies asserted that the stringent separation of commercial from rating teams could address this particular conflict of interest. How effective this would be, remains to be seen (Bai, 2010).

Notwithstanding the above views on conflicts of interest, Covitz & Harrison (2003) argued that reputational drivers significantly outweighed any potential conflicts in CRA operations and thus discounted the largely held agency view of inflated credit ratings. To this end, studies which empirically test the validity of conflicts of interest claims help to shed better light on the extent of problems emanating from conflicted positions of CRAs. It may well be that the problem is not as significant as some scholars claim.

4.4.3.2 Lack of competition in the ratings market

Before and up to the enactment of the US Credit Ratings Agency Reform Act (CRARA) in 2006, there were only 5 CRAs registered as NRSROs by the SEC. These were Moody's; S&P; A.M. Best.; Dominion Bond Rating Service (DBRS) and Fitch. Out of these 5, DBRS was the only non-US based NRSRO. The rest were all US-headquartered, with two (Moody's and S&P) jointly controlling over 80% of the global ratings market between them (Mahlmann, 2007). The SEC relied heavily on NRSRO ratings, with at least 44 SEC "rules and forms" specifically hinged on ratings (Hunt, 2009b). The NRSRO designation by the SEC acted as a double-edged barrier to entry for would-be CRA entrants. While a new CRA could not get a "NRSRO status without national recognition, they could not get national recognition without the NRSRO status," (Elkhoury, 2008, p.13). The playing field was thus skewed in favour of the incumbent NRSRO CRAs until the 2006 CRARA, which saw the NRSRO total rise to 10 by January 2009.

The oligopolistic nature of the CRA market played a role in limiting competition, restricting issuer choices for alternative rating agencies and possibly lowering rating competitive standards (Johansson, 2010). Those new agencies that managed to make it into the market still faced insurmountable challenges as issuers preferred dealing with the bigger, more established and reputable CRAs who were favoured and trusted by investors (Deb et al., 2011). The CESR recommendations did not address this issue, but skirted around it. No direct proposals were made to address this seemingly important aspect of the ratings market. The limited oligopolistic market may have acted as a disincentive to competition based on rating accuracy and quality (Lamandini, 2008).

For now, attempts to remove entry barriers may have been made but it remains to be seen whether any new CRAs can operate sustainably in light of their perceived lack of clout. The issue of competition therefore needs further investigation to determine the correlation between ratings inflation and competition together with potential impacts on the operations of the rating markets.

4.4.3.3 Lack of transparency

One of the challenges with the way CRAs work is the opaque environment within which they generate ratings. The lack of clear processes and rating procedures, together with the technically complex information (LaFrance, 2009; Rousseau, 2009) make it difficult for rating users to use market information and judge CRA performance (Elkhoury, 2008). In mitigation, the IOSCO code of conduct, originally published in December 2004 (revised in May 2008) required CRAs to:

1. disclose how their own internal code of conduct complied with each provision of the IOSCO Code Fundamentals,
2. explain any deviations of their own Code of Conduct from the provisions of the IOSCO Code Fundamentals together with how it impacted on the objectives laid out in the Code Fundamentals and the IOSCO-CRA principles
3. Publish their methodologies to enhance transparency

Despite all this, the lack of transparency continued to be highlighted by different commentators (Sy, 2004). Among the criticisms was the fact that CRAs hid behind the veil of secrecy to mask their often misinformed and out-dated analyses (Delamaide, 2008). Proposals to regulate the rating industry thus included remedies for transparency through additional disclosures by CRAs (Hill, 2004; Sy, 2009). A pertinent question remained though; who would monitor the additional disclosure and what impact might that additional disclosure have on other objectives such as increasing competition by breaking down entry barriers? There was no evidence that additional disclosure would address the problems highlighted above. If anything, there was a risk that additional disclosures could impose additional costs through resource requirements for handling such additional disclosures, thereby further hindering entry by smaller players in the industry. This would consequently have an adverse impact on competition.

4.4.3.4 Lack of accountability

While ratings were so disclaimed as to question their validity (Partnoy, 2001), investors and regulators were said to have heavily relied on them, (SIFMA, 2008), almost defaulting to ratings as opposed to relying on internal due diligence (Davies, 2008). This anomaly was in stark contrast to the lack of accountability in the CRA business model. The fact that CRAs' ratings were consumed by investors who did not pay for or influence the generation of such ratings further absolved CRAs of any direct accountability to their consumers. The endorsement of CRA operations in Basel II further saw their ratings incorporated into the regulatory rules for monitoring global risk, (Elkhoury, 2008). This may have further entrenched CRAs as almost a law unto themselves, echoing sentiments by Friedman, (1996), cited in (Partnoy, 2001, p.2)

> *"There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful."*

Despite their expanded role, there has so far been no mechanism to safeguard both issuers and investors from potential mistakes made by the powerful CRAs (LaFrance, 2009). This lack of recourse raised questions firstly about the governance / regulation around CRAs, and their own proactive initiatives to address such concerns in the market. There was seemingly blind faith in the use of ratings, yet there were no assurance mechanisms behind the generation of such ratings (Papaikonomou, 2010; White, 2010b). While the new regulatory initiatives broadly covered all the above issues, there has not yet been any change demonstrating that the regulations are taking the desired effect. This raises further questions about how well-thought-out the regulations were and whether they have a compelling enough force to ensure compliance.

4.4.3.5 Ratings Quality

The quality of ratings has been subject to scrutiny by a number of researchers (Cantor & Mann, 2007; Duff & Einig, 2009a; Krahnen & Weber, 2001), owing to concerns that as the asset-backed securities market grew between 2002 and 2006, so did the complexity of the market.

Notwithstanding this growth, it did not appear that the quality issues of ratings were addressed in a commensurate way. The following are some of the selected previous studies carried out in the area of ratings quality:

Table 14: Selection of studies investigating rating quality

Author	Study	Main Findings
Czarnitzki and Kraft (2007)	Carried out an empirical investigation of loan defaults among Western German manufacturing firms	Concluded that ratings were indeed efficient predictors of default. As they used comparative studies of ratings plus publicly available information without the rating, the conclusion was that the combined approach offered more mileage than the separate approach
Duff and Einig (2009)	Surveyed 4 UK-based stakeholder groups (comprising 121 issuers, 75 non debt issuing financial managers, 90 investors and 120 other interested parties) to construct a ratings quality measurement instrument.	Came up with a two-pronged approach to measuring ratings quality; Technical Qualities and Relationship Qualities broken down into sub components which were empirically tested and validated in the market.
Pagano and Volpin (2009)	Investigated the contribution of coarse information and disclosure as well as ratings inflation to the 2007 crisis	Concluded that there was need for greater disclosure and that the issuer-pays model was fundamental to the challenges leading to the crisis.
Ponce (2011)	Empirically studied the shift from investor to issuer-pays to determine the effect on ratings quality using Moody's rating data	Concluded that the switch in models resulted in deterioration of ratings quality

Source: Compiled by author

According to Frost (2007) rating accuracy (and hence ratings quality) is derived from the information usefulness and timeliness of ratings, enabling users to make informed decisions. Despite the increased reliance on ratings by both regulators and market participants, ratings quality allegedly remained hazy, without any specific metrics (Rousseau, 2009). In a separate study, Pagano & Volpin (2008) carried out an investigation that concluded that ratings quality remained an issue, with the quality of ratings compromised by the conflicts of interest embedded in the issuer-pays model. This view was echoed by Ponce (2011) whose study concluded that the switch from the investor-pays to the issuer-pays model had a detrimental effect on ratings quality. From the above studies, there is a positive correlation between ratings quality and market confidence.

Ratings quality is therefore essential for well-functioning securities markets, particularly as there is no alternative to the regulatory use of ratings as yet. Any meaningful regulatory proposals need to address the issue of ratings quality and ensure that this is defined in objective, measurable terms for transparency. As if in response to this gap, Duff & Einig (2009a) carried out an empirical study that resulted in the construction of a ratings quality model. Notwithstanding their proposed model, there was no evidence as yet that CRAs had adopted any visible common methodologies evidencing ratings quality.

Enron is commonly cited as an example of a rating that was maintained at above investment grade levels until a few days before the company filed for bankruptcy on 28 November 2001, (Hunt, 2009a; Rousseau, 2009). This is in contrast to a downgrade of Enron by Egan Jones more than a month before the collapse (LaFrance, 2009), a downgrade that seems to have been somewhat side-lined by the market. The Enron rating raises questions that touch on the business models of CRAs, particularly considering that Egan Jones used an investor-pays approach and seems to have been ahead of the curve in noticing Enron's deteriorating asset base. It may be just coincidence that the issuer-pays model was on the back foot, while Egan Jones and the investor-pays model were ahead of the market in anticipating Enron's impending default. This however raises interesting questions all the same, particularly in view of the criticisms levelled against the model as discussed earlier. The quality of ratings may have a direct link to the quality of information that CRAs receive from issuers and subsequently base their ratings on.

Notwithstanding that, one would expect CRAs to at least verify any information received or carry out their own due diligence to protect their own reputations. Evidence of the Enron and other debacles suggests that this was not always the case (Walker, 2010). As the area of asset-backed securities was relatively new to CRAs, questions are being asked about CRAs competences, governance structures and the robustness of their methods in this area (Crouhy, Jarrow, & Turnbull, 2008). There is perhaps an underlying issue of trust in the relationships involved (for example, did CRAs trust issuers too much, thereby compromising their ability to be critical?). If the different entities defaulted to relying on trust, this may have had a detrimental effect on the ability to question and challenge.

The above and other issues have prompted an evolving debate touching on the need for CRAs to be regulated (Pettit et al., 2004; Crotty, 2009; Gupta, Mittal, & Bhalla, 2010; Pettit, Fitt, Orlov, & Kalsekar, 2004; Sy, 2009). A brief overview is given below.

4.4.4 Regulation of Credit Rating Agencies

The following are a selection of some of the studies contributing to the debate on the regulation of Credit Rating Agencies.

Table 15: Studies debating the role of regulation in credit ratings

Author	Study	Main Findings
Avgouleas (2008)	Concept work advancing proposals to overhaul the regulatory approach and usher in a new regime incorporating registration supervision and monitoring of CRAs	Concluded that most regulatory attempts focused on containing the current crisis rather than preventing future ones; ignore behavioural issues in the crisis. Proposed a transnational regulatory body to supervise financial institutions globally
Sy (2009)	Concept paper focusing on the contribution of CRAs to the 2007-8 crisis	Argued that while regulation proposals focused on micro-prudential regulation, the focus should be on macro-prudential regulation
White (2010a)	Concept paper chronicling the background to the CRA debacle and calls for regulation	Argued that more regulation would impede market efficiency and not deliver the desired effects. Proposed a reduction in regulatory reliance on ratings as opposed to increased regulation per se.
Nichols et al (2011)	Provided an empirical test on the contribution of poor government policy choices to the financial crisis	Concluded that rather than prevent the next crisis, current regulatory efforts could fuel the decline towards a crisis due to lack of understanding of finer market operational details. Evidence showed that previous regulatory attempts never worked, raising questions on whether latest EC regulatory attempts would work.
Utzig (2010)	Reviewed drivers for and possible implications of the EC regulations	Argued that while the regulations could improve corporate governance of CRAs, the regulatory scope was too narrow and failed to address some fundamental issues such as competition in the industry
Papaikonomou (2010)	Sought to identify areas for further inquiry with regards to the regulation of credit rating agencies as well as gather evidence of the need for a paradigm shift	Proposed a global approach to regulating CRAs as a way of addressing systemic risks. Questioned whether current regulatory conceptions were adequate

Source: Compiled by author

Perhaps one of the most enduring debates on credit rating agencies relates to calls for credit rating agency regulation (Forster, 2008; Papaikonomou, 2010). Views in this area have been polarised, with the pro-regulation advocates citing legacy problems inherent in CRA business models as well as lack of competition as reasons justifying external intervention (Partnoy, 2001). The opposing view has argued that the securities market is not amenable to regulation and that any attempt to regulate may have adverse unintended consequences on market operations (Theis & Wolgast, 2012; White, 2010a).

Despite the alleged CRA failures leading up to the 2007-8 crisis, there were divided views on whether to regulate them or not (Naude, 2011; Nichols et al., 2011); what form of regulation could be pursued (Gaffeo & Tamborini, 2011; Pacces, 2010); the extent of regulation (Pavlat, 2009); as well as the appropriate regulatory authorities to provide effective oversight (Baldwin et al., 2012). Other views raised concerns on the possible unintended consequences of the EC regulations and the possible debilitating effect these could possibly have on the market (Avgouleas, 2010). Yet other views condemned the latest regulatory reforms as reactive, and not well-thought through (Fisch, 2010).

Such diverse views raised questions about whether regulation was the answer to the problems besetting the rating industry, if so, which form of regulation would pacify all the stakeholders (if possible); how such regulation could best be implemented, by whom and to what effect? Also, specific questions were raised about the effectiveness of the EC regulatory reforms in addressing legacy issues in the ratings market. Nichols, Hendrickson, & Griffith (2011) argued that rather than prevent the next crisis, current (and previous) regulatory efforts could fuel the decline towards a crisis due to lack of understanding of the intricate workings of the market. Judging by the history of previous crises and subsequent regulatory efforts meant to stem subsequent crises, it is difficult to dismiss this fact altogether. Sy (2012b, p.75) argued that

> *"Each crisis has something sufficiently novel to capture public imagination: in 1987, it was junk bonds and portfolio insurance; in 1998, it was fixed income arbitrage and LTCM; in 2000, it was the information technology boom and Enron; in 2007, it was sub-prime mortgage securities, and so on. All these crises may be considered to have originated from the economic paradigm, which provided the moral umbrella to pursue self-interest by whatever inventive scheme, so long as no laws were seen to be broken."*

From this perspective, market participants seem to have a way of innovating beyond regulatory confines such that the next crisis manifests itself in a unique form, not succinctly captured by previous regulatory conceptions. Throughout the history of credit ratings and in particular, when ratings became embedded in regulatory frameworks, there were calls for rating agencies to be regulated (Crotty, 2009; Gupta, Mittal, & Bhalla, 2010; Pettit, Fitt, Orlov, & Kalsekar, 2004; Sy, 2009).

Such calls increased particularly in response to crises. After the inception of the EC regulations, there emerged a new view that argued that regulation may not be the way to address the problems in the ratings market after all (White, 2010b); that current regulatory proposals were not sufficiently forward-looking and therefore may not prevent the next crisis, (Nichols et al., 2011) and that the regulatory focus was too narrow (Papaikonomou, 2010; Utzig, 2010). At a time when regulators may have thought the problem was under control, these new views regarding the possible inappropriateness of regulation mean that the search should continue for an evolving but appropriate framework. As discussed earlier, literary evidence suggests that key questions regarding the EC regulatory proposals could centre around:

(i) possible negative effects of increasing competition which could fuel rate shopping and exacerbate ratings inflation;
(ii) increasing compliance costs particularly for new smaller entrants thus acting as a barrier to entry;
(iii) Bombarding the market with unwieldy additional disclosures without anyone necessarily equipped to deal with the additional disclosure
(iv) Possibly causing regulation arbitrage
(v) Possibly fuelling regulatory tourism and
(vi) From studies of previous regulatory attempts, there is no evidence that regulation can prevent future crises as it is modelled on past crises, there are questions on whether these latest EC regulatory attempts will be any different (Davies, 2003).

It is important to review the alleged CRA contributions to the crisis which acted as a trigger for the EC regulations. The following section briefly reviews the alleged CRA contributions to the 2007-8 crisis.

4.5 How CRAs allegedly contributed to the global financial crisis

While blame for causing the crisis cannot justifiably be laid solely on any single entity, CRAs have been singled out as having contributed significantly to causes of the 2007-8 financial crisis (Deb et al., 2011; Johansson, 2010; Richardson & White, 2009; Sinclair, 2010). This, it is argued was because CRAs encouraged the growth of the structured products which played a leading role in fuelling the crisis (Katz, 2002).

The opaque pooled assets appeared relatively risk-free to many investors owing to the structuring process and the ratings given by CRAs which effectively masked the underlying risks. When the underlying assets deteriorated, CRAs were not quick enough to downgrade the pooled securities and alert investors on time. The charge in this area is therefore failure to adjust their ratings in a timely manner (Strier, 2008; White, 2010b). Briefly, the role of CRAs in the crisis can be summarised as follows:

4.5.1 CRAs underestimated structured product risks

CRAs are said to have underestimated structured product risks and failed to respond in a timely manner to adjust their ratings to reflect the degenerating conditions in the structured products (Johansson, 2010; Utzig, 2010). Analysed closely, this constitutes a failure on the part of CRAs as gatekeepers / information intermediaries whose timely opinions would have alerted investors to possible corporate collapses, allowing them to restructure their investments decisively. There is a possible counter-argument which asserts that considering the relationship between CRAs and investors, CRAs were not accountable to investors and therefore did not owe investors any duty to report any rating (opinions) movements. This owes to the fact that they did not have a contractual relationship with investors. Such an argument would discredit the value of ratings and the role of CRAs as information intermediaries in financial markets.

The conclusion is that if CRAs are to be taken seriously as holders of key market information to be valued by investors, regulators and the public, then such information should be credible and worth the attention that it gets. On this account, CRAs indeed failed rating users who relied on their information. Further, as gatekeepers, they failed to stop wrongdoing through sanctioning information within their domains.

4.5.2 CRAs failed to provide timely monitoring of rate transitions

CRAs failed to monitor deteriorating rate movements in such corporates as Enron, WorldCom, Parmalat and more recently, Bear Sterns, Lehman Brothers, AIG among others. At the centre of the accusations against CRAs, is a charge of flawed rating methodologies (Coffee, 2009; Shorter & Seitzinger, 2009).

CRAs' methodologies were said to be opaque (LaFrance, 2009), meaning that other market participants found it difficult to judge for themselves whether CRAs were doing a good job or not. The lack of CRA accountability to consumers of their information and the absence of robust regulatory oversight could have meant that CRAs became complacent and standards may have fallen.

A counter-argument could posit CRAs as self-interested entities that would have been driven to do well in monitoring ratings but when possible conflicts of interest were brought into the mix, it may have been easy to conclude that because of their role as advisers of issuers in the structured process, CRAs may have found themselves in a compromised position of whether to go against their clients and issue negative advisories to the market about the very products that they helped to structure. Either way, CRAs faced harsh repercussions (Gupta et al., 2010). If issuers paid for the structuring advice given by CRAs on how to structure their securities for better ratings, possible downgrades would have dented the quality of structuring advice, potentially damaging the relationships between issuers and CRAs. This would be hurting CRAs' potential future sources of revenue. The reverse side would have been delayed issuance of ratings, risking CRAs' reputations in the market.

Whatever choice the CRAs opted for, whether this was a deliberate act of commission or omission, they did not issue warnings in time and their failure to do so raised many questions about their competence as well as their objectivity in playing the role of financial market gatekeepers.

4.5.3 CRA models and rating regimes gave false impressions of underlying asset risk

There are pervasive questions around the comparability of ratings in sovereign, bond and structured finance products. Ratings for sovereigns, corporate bonds and structured products all use the same rating symbols, suggesting to lay-people that the process and underlying asset structures may be comparable albeit different factors going into each rating type. This raises questions on the assumptions underlying the rating processes for sovereign, corporate and structured products.

The asset structures underpinning each of the 3 rated areas are vastly different, yet the use of similar rating symbols connotes some uniformity in the rating approach and significance of such ratings. Different symbols would give each of the rating types their deserved uniqueness and would conjure differences in the underlying asset structures and processes.

4.5.4 Possible inadequate governance arrangements to mitigate conflicts of interest

There are allegations of possible inadequate checks within CRA governance systems leading to problems associated with conflicts of interests and analytical independence. This alluded to the fact that commercial interests could have possibly overtaken analytical independence and subsequently compromised rating quality, (Johansson, 2010). As discussed above, the role of CRAs as advisers to issuers, particularly advising on structured products placed them in a compromised position of possibly having to align themselves with the issuing institutions that they rated. It would be inconceivable for CRAs to turn against the advice they would have given earlier and subsequently rate it as poor. With this background in mind, it would appear there were governance lapses in CRAs which positioned them more as advisers rather than as raters.

Their allegiance to market participants such as investors who did not pay for their services is therefore questionable, particularly if it meant they had to stand aloof and denigrate their paying clients (issuers). Facts on the ground may be different but analysis of the relationship dynamics suggests that CRAs indeed failed to demonstrate independence in this regard.

4.5.5 Possible competitive behaviour leading to ratings inflation

Possibly compromised rating standards emanating from rate-shopping by issuers could have possibly contributed to competitive and inflated ratings among CRAs. This alludes to the fact that issuers could downplay unattractive ratings and inadvertently pressure agencies to provide more positive ratings, (Utzig, 2010). Bearing in mind that issuers preferred higher ratings, it is logical to assume that they would select an agency with prospects of higher ratings. Normal competitive dynamics would suggest that if a CRA found that its ratings were competitively disadvantaging it, it would logically seek to adapt its processes and marketing to

suit client requirements. While this is a logical act for any marketing organisation, the role of CRAs means that going down this route could compromise ratings as CRAs would be seeking to issue 'favourable' ratings to please their paying clients rather than issue objective ratings. Based on these facts, it is logical to conclude that CRAs' failures to provide accurate ratings on time could also have been influenced by the rate shopping behaviour of issuers.

Underlying some of the above alleged failures by CRAs is the problem of securitisation, which involved the bundling of mortgages into Collaterized Debt Obligations, (CDOs) which were later pooled and sold as securities (Davies, 2008). Investors buying these securities relied on Credit Rating Agencies to act as the first line of defence as they themselves were divorced from the detailed risks embedded in the underlying pooled mortgages. It would appear though that rating agencies may have been used as the only line of defence, suggesting that investors themselves were also to blame for blindly using ratings and not doing enough of their own due diligence. The performance of CRAs in structured finance was found to be unsatisfactory by ESME, (ESME, 2008). In addition, investors themselves were found to have lacked adequate internal systems to conduct their own due diligence.

Having discussed legacy issues in the credit rating industry and how CRAs are said to have contributed to the crisis, the next section briefly reviews the regulatory arrangements prior to, and leading up to the 2007-8 crisis.

4.6 Regulatory initiatives prior to the 2007-8 crisis

The publication of the IOSCO Code of conduct in 2004 was the first international collaborative attempt to rein in the operations of CRAs (Elkhoury, 2008). The code was to be monitored and enforced by CESR, and was specifically aimed at:

- Establishing a governance framework that would bring consistency, quality and integrity to the ratings process internationally;
- Ensuring an independent, unbiased ratings process
- Instituting transparency as well as
- Eliminating conflicts of interest inherent in the CRA business model.

Table 16 below summarises the regulatory arrangements in place both in the EU and the US, highlighting some of the regulatory implications.

Table 16: Regulatory initiatives in the US and the EU prior to the 2009 EC Regulations

	US	EU
Main regulator	**SEC**	**Bank supervisors**
Regulatory tools	No registration of CRAs, but recognition by SEC of NRSRO for regulatory purposes	No registration of CRAs, but CRAs recognised by bank regulators for regulatory purposes
IOSCO Code	SEC did not recommend adoption of IOSCO code by CRAs but the NRSRO recognition criteria relating to conduct of business rules seemed likely to be achieved by implementing the Code.	CESR recommended adoption of the IOSCO Code by the CRAs. There was no enforcement mechanism (CESR relied on voluntary market enforcement)
Recognition criteria	- Published ratings - Market acceptance of CRAs - Conduct of business rules	- Integrity of methodologies - Credibility of ratings - Conduct of business rules
Recognition goals	Efficiency of securities markets	- Efficiency of securities market (IOSCO Code) - Adequacy of capital requirements
On-going supervision	Limited (SEC reserved the right to re-examine conditions on which the NRSRO status was granted)	Permanent (as required by the CRD)
Recognition procedure	SEC discretion, although criteria were more precise under the Proposed Rule	Bank regulators were bound by the CRD rules and further details
Civil liability	None, (First Amendment protection)	Never established but possible
Securities laws	Exemption under Regulation FD	No exemption under the Market Abuse Directive, (MAD)
Competition	The SEC believed that more precise NRSRO designation criteria would foster competition and that competition was a means of regulating CRA performance	CESR believed that competition issues were not supposed to be taken into account in establishing CRA rules and should be left to antitrust authorities.

Source: *Champsaur (2005, p.46)*

As can be seen from Table 16 above, despite being a commendable start, the IOSCO code was voluntary, based on a 'comply or explain' basis, giving CRAs an escape route if they could explain any non-compliance. Neither CESR nor the IOSCO code had any compelling powers to clamp down on rogue CRA practices. Instead, CESR recommended the adoption of the Code and meanwhile took a 'wait-and-see' attitude (Champsaur, 2005; Elkhoury, 2008). Effectively, it was down to each country regulator to ensure that within their jurisdictions, CRAs complied with the code. Beyond that, there was no active international regulatory effort to coordinate reporting of performance against the code and bring erstwhile CRAs to book. The innovative nature of structured finance products and the dynamic nature of the industry raised pertinent questions on whether regulators could competently cope with the increasing complexity in the highly-dynamic industry.

Unlike the current registration requirements for CRAs operating in the EU (see for example Sy, 2009; Utzig, 2010), there were no registration requirements in the EU prior to the 2007-8 crisis and each market dealt with CRAs in isolation. Viewed from this perspective, CRAs were not strictly held accountable, particularly in the EU. Where they were, this was patchy and isolated; CESR seemed to be a tokenistic regulator without any powers to compel compliance with the IOSCO Code.

There were no specific actionable steps to address competition-related problems in the EU. Prior to the EC CRA regulations, credit rating agencies were registered in the USA and regulated by the Securities Exchange Commission, (SEC), after the new Credit Ratings Reform Act of 2006 gave the SEC that mandate. There were no similar regulatory structures in Europe or anywhere else in the world prior to the 2009 EC CRA regulations, (Davies, 2008; SIFMA, 2008). This created a regulatory void which fuelled calls for regulation, particularly in the EU (Choi, 2004; Partnoy, 2001).

4.6.1 Market directives governing CRA conducts in the EU

In the absence of a singular regulator for CRAs in the EU, 3 directives broadly covered the activities of CRAs operating in the EU; the Market Abuse Directive, (MAD) targeting market manipulation and insider dealing through enhanced transparency; the Capital Requirements Directive, (CRD), looking at essential criteria for CRAs to be recognised as External Credit Assessment Institutions (ECAI).

The last directive was the Markets in Financial Instruments Directive (MiFID) which only focused on those CRAs engaged in undertaking investment services over and above their conventional rating activities. The MiFID stipulated some requirements on the structure of CRAs as well as CRA business conduct, including a tight ruling for them to adopt the IOSCO Code and incorporate it in their internal policy procedures. At an operational level, it was loosely left to CRAs to comply with the IOSCO code of conduct or explain their non-compliance, (Rousseau, 2009). CESR had the mandate to monitor compliance with the IOSCO code, reporting annually to the European Commission. The first such report by CESR was in December 2006 (ESME, 2008) and indicated that CRAs had generally complied with the IOSCO code, prompting the Commission to conclude that there were no grounds for proposing further regulation in the European CRA landscape.

By October 2008, following the 2007-8 global financial crisis, the above view had changed and the resolution was that CRA regulation was vital to restore market confidence and protect investors. This was further strengthened by the G20 communiqué of April 2009. The initially proposed framework was not dissimilar to the previous arrangement and still had IOSCO as the standards body and CESR as the enforcer of the standards.

Despite the IOSCO code having been positioned as the international framework to provide oversight on CRA activities, the end of 2009 paradoxically saw IOSCO waking up to the fact that "..neither IOSCO nor any other international body currently is in a position to determine whether or not a given [credit rating agency] in fact complies with its own code of conduct in the manner in which its public statements indicate" (IOSCO, 2009, p.3). Bearing in mind that nothing had changed in the way CRAs operated and neither had CESR's role changed, the above IOSCO view begs the question as to what compliance role CESR had previously played and how such a role was brought to bear. CESR had previously written compliance reports attesting to the fact that CRAs were generally complying with the code. This raises the question as to how such compliance would have been measured and the accuracy thereof verified. Section 4.8.2 briefly discusses the regulatory gaps that were perceived to exist leading up to the 2007-8 crisis.

4.6.2 Perceived regulatory gaps prior to the 2007-8 crisis

While the SEC had policing powers over CRAs in the USA, it lacked the authority to regulate the substance of ratings or the CRA processes and methods used to derive the ratings (ESME, 2008). This distant regulatory relationship was as good as no regulation because essentially, CRAs were not held to account in the specific ratings they dished out. Both the EU (CESR) role and the US (SEC) role left a gap at local and international levels in ensuring a coordinated regulatory approach to CRA activities. The patching up of the global regulatory approach was seemingly founded on a weak framework and called for a complete overhaul of the CRA business model. As CRAs operated in different global markets (CESR, 2009), the lack of a joined-up international regulatory framework left many governance loopholes in the global financial market in general and the CRA market in particular (Johansson, 2010).

The publication of the 2003 'IOSCO Statement of Principles' on CRA operations and subsequently, the Code of Conduct Fundamentals for Credit Rating Agencies one year later were attempts to provide a framework for holding CRAs to account, particularly in the EU. The major flaw of this approach was that it was based on the 'comply or explain' self-regulation model (Katz et al., 2009), without any effective monitoring mechanism to hold non complying CRAs to account. The UK tends to adopt the common law approach not akin to comply or explain (see for example Brunnermeier, 2009). There have been pervasive debates on whether the more rules-based approach would serve modern financial markets better (La-Porta, De-Silanes, Shleifer, & Vishny, 1998). The comply-or-explain approach cited above effectively meant that CRAs who failed to comply could possibly explain their way out of further scrutiny. Guidance documents and procedural proposals for reforms were forthcoming. While this indicated a level of interest and involvement by different parties, in the absence of an absolute singular authority, it caused confusion and left a regulatory void. While CRAs had to comply with stringent SEC requirements in the US, across the channel, they did not have much compliance requirements, a situation that could cause regulatory tourism and is said to have contributed to the 2007-8 crisis discussed in the ensuing section.

4.6.3 The 2007-8 global financial crisis

A financial crisis is defined as a "situation in which confidence in financial institutions or markets generally is lost, or where there is an actual, or a serious risk of collapse in the whole financial system which would generate collateral damage even for savers and investors who are not directly linked to the institution or institutions that are the source of the crisis" (Davies, 2003, p.26). While a great deal of blame has been placed on CRAs, the crisis was largely a systemic one, with multi-faceted problems and contributing factors. Currie, (2006) asserted that a systemic financial crisis involved the following four phases:

a. Stage I - begins with a sharp, sudden fall in the prices of securities and derivatives.
b. Stage II - witnesses the spreading of price falls from one market to another.
b. Stage III – sees the effect of the preceding stages on international financial intermediaries, leading to the failure of one or more, which could endanger the system through the effects on the liquidity and solvency of interdependent participants.

c. Stage IV—the effect Stage III has in generating a crisis in the core banking and payments system of the national economies, (Currie, 2006, p.50).

The 2007-8 crisis saw the passing of all the above phases across the globe with catastrophic consequences. Financial crises can originate outside the banking system but eventually permeate different areas of the financial system with debilitating effects. To stem them, regulators tend to take “an integrated approach” (Davies, 2003, p.27), lest they risk tinkering around the edges and leaving the problem. An integrated approach requires looking at the relationships and exchanges between parties in financial and capital markets. Such exchanges may be domestic as well as international or global. This therefore means that effective financial and capital market regulation in a globalised market cannot be rooted domestically without inter-jurisdictional coordination. Such a localised approach may lack jurisdictional effect across borders and could lead to regulatory arbitrage (Lannoo, 2009). An integrated approach therefore means regulators have to seek international as well as a global approach to stem contagion which may originate in one market but have devastating effects on other connected markets. This challenges the EC regulations to seek possible collaborative approaches with other regulators so as to have seamless regulations capable of operating across different markets, particularly in an innovative, globalised world.

4.7 Other significant catalysts that led to the 2007-8 financial crisis

The following are other notable catalysts that are perceived to have had a significant contribution towards the 2007-8 crisis. Any meaningful remedies to stem the crisis would need to consider all the contributory factors to avoid a piece-meal approach.

4.7.1 Innovation as a catalyst for crises

The innovative and complex securitized products that were churned out prior to the global financial meltdown revolutionised the face of global securities and capital markets (Davies, 2003). Innovation in the financial market was said to be directly attributable to regulation (Calomiris, 2009), which, while limiting allowable activities on one hand, inadvertently encouraged the “arbitraging of regulatory capital requirements by booking assets off the balance sheets of regulated banks...”

(Calomiris, 2009, p.66). The allowable off-balance sheeting of assets enabled the regulated institutions to remain seemingly compliant with the relevant regulations while behind the scenes, they had shed off significant liabilities to their off-balance sheet vehicles (Brunnermeier, 2008). This represented an innovative approach to dealing with what institutions at the time may have perceived as constraining. These acts however represented a form of regulatory arbitrage (Dothan, 2008) and have not been without their ills. The very fast pace of innovation may have resulted in information asymmetry and knowledge gaps, particularly on players such as regulators and investors who now may have had to rely on being brought up to date on the developments in the market (Crockett, 2003). With the regulations now in place, new questions have emerged, questioning whether crises can really be prevented and if so, what form of regulation would be appropriate for doing this effectively (Crockett, 1996). These questions are briefly discussed in the following sections.

4.7.2 Can crises be prevented?

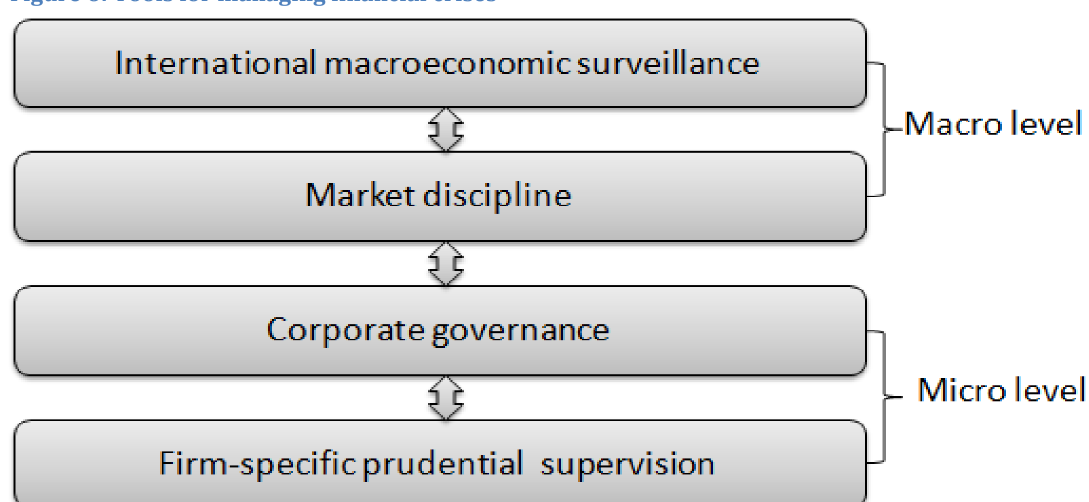
International financial crises can never be completely eliminated (Davies, 2003), rather, their probability of occurrence and possible impact can be minimised. A study by Eichengreen & Bordo (2002) concluded that modern financial systems were twice as likely to fail compared to the pre-1914 era. This, they argued, emanated from globalisation, rapid innovation and liberalisation which made financial systems interdependent, dynamic and unstable. Davies (2003) acknowledged that one of the tenets of a progressive, innovative and dynamic international financial system, was its propensity to fail.

So as humans progressively innovated, creating more wealth, the system increasingly became fragile and fraught with risks emanating from its various global roots. As new products are tried, there are immense risks but these have to be prudently taken if the market is to continually innovate. Each crisis tends to be triggered by different sets of events for example junk bonds led to the 1987 crisis (Wade, 1998); Long Term Capital Management (LTCM) and fixed income arbitrage in 2008 (Bianchi & Drew, 2010); the dot com bubble in 2000 (Carmassi, Gros, & Micossi, 2009); subprime mortgages in 2007 among others (Sy, 2012).

The implication is that the market seems to innovate ahead of regulation and that regulation can best seek to minimise the impact rather than design a fool-proof system as this may constrain innovation and stifle growth (Porter & Van der Linde, 1995), thereby going against the economic paradigm driving wealth accumulation.

Seemingly, a balance has to be struck between reckless risk-taking on one hand and the wellbeing of the global market on the other. There is an implicit assumption therefore that financial market innovation is welcome as long as it serves sustainable global financial markets well. Arguably, risks associated with this have to be borne by the global markets. Through effective and proactive oversight of financial players, crises can be stemmed, perhaps not entirely prevented. Davies (2003) referred to four tools that could be deployed to regulate financial markets and minimise risks. These are summarised in Figure 6 below.

Figure 6: Tools for managing financial crises



Adapted from Davies (2003, p29)

The implications of Davies, (2003)' framework above are that an integrated regulatory approach incorporating governance structures at company level, transparency and disclosure as well as broader market oversight issues is required for financial discipline. This calls for competent regulators who are in touch with market issues; are dynamic and proactive to anticipate market developments and put in place requisite regulatory provisions (Alexander, Dhumale, & Eatwell, 2005).

The framework recognises the interconnectedness of the global market and calls for coordination and either harmonisation of regulatory systems or adaptations to cater for different systems with appropriate measures put in place to handle any differences. If different regional or national regulatory systems are handled separately, then the interfaces need to be coordinated for a seamless global or international system (Braithwaite & Drahos, 2000). With the above background in mind, the EC regulations can now be put into perspective. The section below briefly discusses the European Commission Credit Rating Agency regulations.

4.7.3 The European Commission Regulations on Credit Rating Agencies

Already, the 2009 CRA regulations have been met with mixed responses (see for example Hassan & Kalhoefer, 2011; Johansson, 2010; Utzig, 2010). Opinions were (and still are) divided not only on whether the regulations will work, but also on whether regulation is the most appropriate response after all. Some commentators have argued that the regulations fail to address the legacy issues in the CRA business model and may instead have some unintended consequences in the market (Acharya, Cooley, Richardson, & Walter, 2010; Kravitt, 2012; Voorhees, 2012). As if in response to these concerns, the EC issued some regulatory amendments to address various issues that had not been adequately covered in earlier regulatory versions. Table 17 offers a timeline of the EC regulatory initiatives to date.

Table 17: The EC regulation timeline

Time	Action / Decision
2001	Following the collapse of Enron, CESR carried out a study for the European Commission and concluded that regulation of CRAs was not necessary. The EC instead placed reliance on the IOSCO code, designating CESR to ensure CRAs compliance by issuing annual compliance reports.
2006	After the first CESR annual report, the EC concluded that there was insufficient evidence justifying CRA regulation as CRAs largely complied with the IOSCO Code according to the CESR Compliance report.
2009	Following the 2007-8 financial crisis, the European Parliament adopted a "Proposal by the EC for Regulation on Credit Rating Agencies" Exact CRA supervision details remained sketchy
June 2010	The EC proposed a revision to its 2009 regulation provisions by opting for the creation of a pan-European regulatory body – the European Security Markets Authority (ESMA) – that would be given exclusive supervisory authority over CRAs registered in the EU. ESMA was to have powers to investigate, impose fines, and suspend or terminate a CRA's license in case of breaches or non-compliance.
Dec 2010	EC rules became effective
Jan 2011	ESMA was established on 1 January 2011; ESMA consultation and guidelines on endorsement allowing 3 month grace period
June 2011	Klinz proposal for further amendments (CRA3). Klinz report approved in June 2011 by EU Parliament

Source: Compiled by author

Close scrutiny of the timeline above reveals interesting about-turns by the EC on the regulation of Credit Rating Agencies in the EU. Of further interest is the fact that despite being mandated to report annually on CRA compliance with the IOSCO code, the first report by CESR on CRA compliance to the IOSCO Code was 5 years after the 2001 mandate to monitor CRAs was initially granted to ISOSCO (St. Charles, 2010). Details of what this monitoring involved and how compliance was verified remain sketchy. It is questionable that any strict adherence to the code was enforced as CESR subsequently admitted that there was no way to verify if CRAs had complied with the code as had previously been reported.

This was despite the 2006 report to the EC confirming CRA compliance to the code. The conclusion drawn from the above is that regulating rating agencies is murky business that requires constant review to ensure that the regulations remain relevant and the regulatory instruments fit for purpose. Of particular note was the question on whether the European Commission got the problems right and whether the regulations are fit for purpose. Following the crisis, the regulations sought to re-establish market confidence and restore some semblance of order in the market. Some broad aims of the EC credit rating agency regulations are summarised below.

4.7.4 EC CRA regulations – broad aims

Since the inception of the regulations in 2009, and their subsequent enforcement in 2010, there have been several amendments. The original set of regulations (CRA1), encapsulated the harmonisation of CRA regulations across the EU. Subsequently, CRA2 transferred the regulatory powers from member states to ESMA and gave ESMA legal powers to enforce sanctions within member states, working with local supervisors. CRA3 further proposed a raft of changes, touching on such issues as changing the CRA business model from the issuer-pays model; the endorsement of ratings; civil liability of CRAs; reduction of overreliance on ratings among other proposals. While the latest round of proposed amendments cut deep and bravely attempted to address the fundamental issues at the heart of the rating agencies operating model, there are fears that they cut too deep, too soon and have not fully allowed for previous efforts to take root (Stolper, 2009).

4.7.5 Implications for the EC credit rating agency regulations

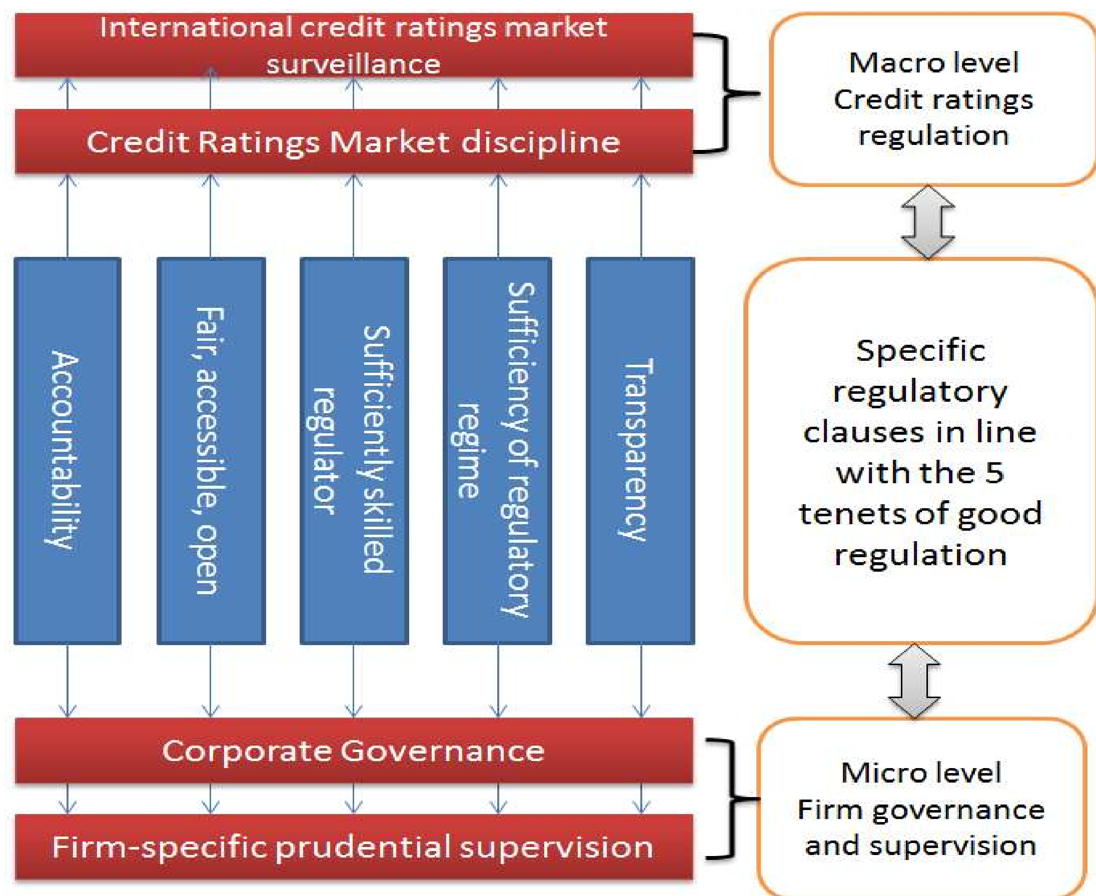
Despite the various amendments to the regulations, there are still dissenting views calling for caution, arguing that regulation may not be the answer to the problems that triggered the 2007-8 crisis (Begg, 2009; Rodrik, 2011; White, 2010a). Other views offered theoretical arguments asserting that the underlying theoretical frameworks in use in the current regulatory regime (and perhaps those proposed) were inadequate and may need updating (Currie, 2006). The conflicted issuer-pays model is still in place and there does not seem to be any viable alternative yet (Johansson, 2010). Latest CRA3 proposals have since been updated and specifically seek to reduce regulatory reliance on ratings as well as find a viable alternative to the issuer-pays model. As yet, it is still unclear how regulators propose achieve the stated objectives of CRA3.

Following the approval of the EU CRA regulations by the European Parliament in April 2009 and the subsequent enactment of the regulations on 7 December 2010, all CRAs wishing to have their ratings used in the EU had to apply for registration with the European Securities and Markets Authority, (ESMA) which was the designated supervisory authority for CRAs in the EU. In the initial proposals, supervision was to be split between CESR and the relevant member state Competent National Authorities (Katz et al., 2009). These arrangements were later amended under CRA3 as the regulations evolved. The implications of these changes have far-reaching ramifications to both market participants as well as regulators. There are seemingly a lot of amendments in the air, which may cause uneasiness among the different participants who may not be sure what will stay and what will be further amended. This raises questions on whether the EC regulations can be considered to be good regulations.

According to Baldwin et al (2012), good regulations need to address 5 key criteria summarised in Figure 7 below. Addressing all the criteria in the figure below ensures that the regulations in question are fit for purpose; do what they were set up to do and achieve this efficiently without wasting resources. The current study therefore sought to gauge market participants' views regarding the perceived impact of the regulations, particularly looking at how well the regulations were perceived to be addressing the original legacy problems identified in the ratings

industry. Evaluating participants' views against Baldwin et al. (2012)'s framework summarising the tenets of good regulations was intended to offer a structured critique of the EC regulations and provide a framework for modelling this study's questions. As Figure 7 illustrates, regulations have to ensure that both micro and macro level prudential issues are addressed, targeting firm level as well as broader industry, national / international level coordination. A well-coordinated international regulatory approach would ensure that there is no regulatory arbitrage, preventing regulatory tourism and creating a balanced and seamless system in a connected world market. While the framework offers a guide on the topical issues to be investigated, the pertinent issues regarding market participants' views, what they consider to be important as well as suggestions for further improvement will come from the participants during the data collection stage of this study.

Figure 7: Tenets of good credit ratings regulation



Adapted from (Baldwin et al, 2012; Davies 2003)

The view of regulated entities in seminal regulation literature is that of passive and silent observers operating in a system largely dominated by regulators (see for example Baldwin & Cave, 1999). This thought will be explored further in the study interviews. From the above sections, regulation of securities should focus on both micro level firm governance and supervision as well as macro level international surveillance. Further, effective regulation should meet the five tenets of good regulation summarised in Figure 7 above. This study will therefore seek participants' views on whether the EC regulation addresses the issues espoused in Figure 7 above. The securities regulation arena is characterised by dynamism, complexity and typically has practitioners who possess more information about their industry than any outsiders attempting to understand the industry. Consequently, the researcher as an outsider will need to give leeway to study participants to steer the conversations towards areas deemed important in the area of securities regulation. It is therefore imperative that the data collection approach takes a naturalist, open approach that allows participants to freely air their views and highlight issues deemed pertinent.

4.8 Previous theoretical frameworks employed in CRA studies

The majority of previous studies investigating credit rating agencies and their ratings largely took economic theoretical perspectives (Cantor & Packer, 1996; Kerwer, 2002; Kisgen, 2006; Skreta & Veldkamp, 2008). The emphasis in these studies was largely on performance of, and the technical aspects of credit ratings; ratings accuracy; relationship between ratings and levels of competition; ratings quality among other attributes. Further, there seemed to be a distinct separation between organisations (conceptualised as actions of individual players) and institutions, (symbolising structures and rules guiding the behaviour of players) treating these two as separate (see for example North, 1990). While this approach advanced the fields of knowledge in understanding the role and efficacy of ratings, their impact on investment decisions among other areas, the behavioural influences of players involved in credit ratings were downplayed.

As early as 1936, Keynes (1936) underscored the role of psychological drivers in economics, implying that a purely technical view of organisational activities may miss out on the human motivations and their influence in broader management and organisation studies.

Further, when applied to the current study, economic theoretical frameworks did not seem to add much in terms of new insights touching on human behavioural drivers that could have contributed to the 2007-8 crisis. This study therefore advances an argument proposing that to get a holistic understanding of the credit ratings market, organisations and institutions need to be treated as parts of a broader system so that they are understood in their contexts with influences on each other examined. It is therefore necessary to take slightly different theoretical perspectives to analyse the credit ratings market as a way of unpicking the behavioural influences at play. Of particular note, an investigation seeking to evaluate the behavioural influences on credit ratings needs to take a holistic view, considering social structures and their impact on the development of routines, rules, norms and how these come about. The logic behind this proposal is that credit ratings are not just technical, but incorporate subjective judgments and rules that are themselves shaped by (and also shape) the behavioural and sociological aspects of the rating institutions (see for example North, 1990). The section below offers an appraisal of some of the theories briefly discussed in this study, explaining why they were not deemed appropriate for further use in analysing phenomena in this study.

4.8.1 Economic regulation

The regulatory void that characterised the ratings market in the EU for many years, coupled with the alleged unfettered power of CRAs suggested the possibility of regulators being captured by CRAs resulting in regulatory inertia, restricting change within the ratings market. Regulation theory and in particular, the capture theory of regulation, was therefore useful in examining the possibility of regulatory capture among EC regulators and their relationships with credit rating agencies.

While regulation capture sounds plausible, there was no evidence that the regulators of credit rating agencies may have been captured although there was a strong indication of heavy regulatory reliance on ratings. This owed to the fact that there was no comprehensive regulatory authority with a requisite legal mandate to oversee CRA operations across the EU (Donnelly, 2010). Instead, there was IOSCO, an international voluntary code based on a 'comply-or-explain' basis. EU markets therefore relied on the US SEC system of NRSROs, IOSCO as well as isolated individual country-based regulators.

Consequently, there was no single competent, coordinated pool of knowledge to manage CRA activities across different jurisdictions within the EU. The seeming adoption of US regulatory norms outside the US may suggest possible regulatory herding where regulators took cues from those markets perceived to be stable or more legitimate and leading in securities. As this issue is outside the scope of this study, it cannot be covered in any more depth.

Discussions in seminal literature by renowned authors (see for example Baldwin, 2008; Baldwin & Cave, 1999; Baldwin et al., 2012; Stigler, 1971) do not emphasise the active participation of the regulated entities in the formulation of regulations. Involvement of regulated entities has largely been in the form of consultations, suggesting the possibility that input may have been sought on an already-determined regulatory agenda. This has several effects; if regulated entities are not part of the determination of the broad pre-regulation agenda; identification and verification of market issues needing to be regulated away may be compromised; if regulated entities do not participate in generating and evaluating different regulatory options and if they generally feel that their voices do not count, implementation on the ground can be challenging due to non-cooperation. This is particularly so where the cooperation of regulated entities is essential to enhance regulatory effectiveness.

In the absence of cooperation from regulated entities, the resulting power tensions where regulators seek to increase their mandate while the regulated entities resist the encroachment of regulatory efforts make it difficult to regulate. Good practice may see regulated entities proactively taking steps to go beyond regulatory requirements not just as a risk mitigating move, but because they genuinely want to advance accountability and transparency standards in their field. Ordinarily, it would be easy to conclude that naturally, markets do not generally welcome external regulations owing to the restrictive effects that it may have on market participants. The EU credit ratings market, was however unique in that calls for regulation and accusations of failings within the credit rating industry had long dented the market. Under the circumstances, it would be logical for market participants to want some kind of regulatory endorsement of their activities to rid themselves of the vilifying accusations in the market.

Following the above logic, regulation should have been welcomed as an external endorsement to restore some confidence in the industry. CRAs had previously been accused of being too powerful and lacking accountability (Partnoy, 2001; Zingales, 2009); lacking competition, (Deb et al., 2011); lacking transparency (Delamaide, 2008; IOSCO Technical Committee, 2004; LaFrance, 2009; Manns, 2009); as suffering from conflicts of interest and potentially biased (Jiang et al, 2012; Strobl & Xia, 2012) among other problems. Such labels evoked negative perceptions towards the ratings industry in general and CRAs in particular. Nothing short of external intervention could wipe away the negativity associated with credit ratings particularly as self-regulation efforts were perceived to have failed (Mulligan, 2009).

From the above, CRAs were not expected to react negatively to regulation overall as this was necessary for their own good as a way of restoring some confidence back into the rating process, provided such regulations were not overly cumbersome. When interviewed, CRA representatives expressed a concern that regulators had not sufficiently engaged market participants or that there had been tokenistic consultations prior to the enactment of the EC regulations. Participants indirectly pointed to the fact that if regulators had done enough engagement of market participants and other interested parties, some of the problems highlighted in this study would have been identified and addressed at the inception of the regulatory process. Such gestures by regulators would have also built rapport and buy-in from the regulated entities, avoiding the numerous amendments that have been made to the initial proposals as well as saving time and money (see revisions from CRA1, CRA2 through to CRA3).

The traditional view of economic regulation theory as postulated by Stigler (1971) therefore did not lend itself well-suited to explaining developments in the EU credit ratings market. Participants' expressions of being left out of the regulatory process suggested a desire for a more inclusive approach to regulation as espoused in Becker (1985; 1983)'s endogenous theory of regulation which is discussed below.

4.8.2 The endogenous regulation theory

As discussed in Chapter 3, the theory of economic regulation provided a possible backdrop for the evaluation of the EC CRA regulations (Kerwer, 2002). This treated the 2007-8 crisis as a market failure that triggered external regulatory interventions (Crockett, 2003; Laffont, 1994). A typical view of this approach would characterise regulation as an exogenous employment of coercive tools (*sanctions or incentives*) to compel compliance towards the achievement of set policy objectives (Hertog, 2010).

An opposite view would argue that when economic agents seek to influence and co-determine regulatory outcomes, the resultant regulations are generated from within, and among such economic players (Sy, 2012). An endogenous approach sees economic agents actively shaping regulations to maximise economic payoffs. The approach tends to engender buy-in by such economic players as the regulations are co-determined. Reiter (1996) described two phases of the endogenous regulatory approach; the first phase involved the interaction of economic and regulatory agents seeking to craft rules of engagement to be used in the second phase, that is, to agree on regulations to be used in future engagements. The second phase was said to involve interaction between the agents for economic pay-offs, that is economic agents going about their business while regulators provided regulatory oversight under the terms agreed in the first phase.

It is worth noting that market failures tend to trigger the interaction of the agents in the first place, hence regulation is meant to restore equilibrium in the market, following a market failure. Each group of players seeks to maximise payoffs and therefore may attempt to change the regulations in their favour. Sy (2012)'s views built on previous work by Bae-Geun, Kaserman & Melese (1989) who categorised regulators as producers and regulated entities as consumers of regulation, all attempting to "adopt a simultaneous equations approach that reflects both firm and regulatory commission behaviour" (p.375).

In their work on endogenous regulation, Im et al. (1989) appraised the expenditures that firms incurred in attempting to influence regulatory outcomes, taking care to balance such expenditures against anticipated benefits or payoffs from the regulation to determine the optimal levels of expenditure and engagement with regulators.

The authors considered the interplay between the firm's expenditure on influencing regulations vs. payoffs, using a regulatory frontier curve to demonstrate the differing levels of the variables until an optimum level was reached.

Becker (1985) reiterated the concerted efforts and expenditure by firms on influencing the regulatory processes, arguing that there was a correlation between the expenditure and the payoffs, with firms constantly adjusting their expenditures in line with expected payoffs.

From the above sections, a number of broad questions arise:

a) Whether the use of alternative theoretical perspectives (aside from the commonly used economic perspectives) can shed new light in evaluating what market participants perceive to be the impact of the EC credit rating agency regulations on the UK securities market operations;
b) What market participants perceive to have been the triggers of the global financial crisis and whether the EC regulations are appropriately positioned to address such causes;
c) Whether the EC Credit Rating Agency regulations are perceived by market participants to effectively address the legacy problems discussed in previous sections and,
d) Whether market participants perceive there to be other viable alternative funding models for possible use by CRAs.

Questions to be explored in this study will therefore centre around the above broad areas which are in turn informed by the extant literature reviewed. Please see Appendix 3 for the interview questions derived from the broad guide topics.

4.9 Chapter summary

The continued growth of the railroads businesses in the 19th century USA fuelled the need for wider bases of investment funds. With more dispersed investors coming into the fold, information asymmetry arose between investors and borrowers. To address the increasing information shortages, CRAs promptly entrenched themselves as providers of information on the investee entities.

CRAs' roles later broadened and became increasingly central to the functioning of global securities particularly with the SEC's enactment of rule 15c3-1 in 1975 and the subsequent designation of the NRSRO status. Despite CRAs playing a pivotal role in bridging information disparities between investors and issuers, it was argued that lack of a commonly accepted conception of the exact role of CRAs led to difficulties in shaping and managing expectations regarding the exact role of CRAs. The contested role of credit rating agencies as information gatekeepers, verification agents, reputational intermediaries or quasi-regulatory intermediaries was analysed to understand the implications on CRA roles and responsibilities on one hand, and market expectations on the other. This analysis helped to address questions on whether CRAs failed in their role or not leading to the 2007-8 financial crisis.

The heavy regulatory reliance on credit ratings was contrasted with the lack of regulation in the ratings market. This was offered as a backdrop against which to analyse legacy problems inherent in the operating model of credit rating agencies. Review of extant literature helped to critically evaluate the increasing unfettered power of credit rating agencies in driving global securities markets, acting as information arbiters that sanctioned the flow of financial information and capital.

Despite the increased important role of CRAs in securities markets, there was no comprehensive regulatory oversight on the operations of CRAs, particularly in the EU. The shift from the investor-pays CRA business model to the current issuer-pays model was said to have raised several concerns about possible conflicts of interest, lack of accountability and prompted calls for tighter regulatory oversight of CRAs.

Various debates ensued, focusing on the role and mandate of CRAs, the quality of their ratings, whether CRAs were be regulated, if so, by whom among other issues. The chapter reviewed various studies conducted to investigate the relationship between ratings and market stock prices; whether ratings led or lagged in the market; the quality of ratings; possible conflicts of interest in the issuer-pays model as well as the effect of rating transitions among other issues. Different regulatory conceptions attempting to provide oversight on the operations of CRAs were considered.

The role of the Securities and Exchange Commission (SEC) in regulating credit rating agencies in the USA was reviewed, together with its alleged unwitting endorsement of CRAs through the designation of the Nationally Recognised Statistical Rating Organisation (NRSRO) status. Regulatory approaches between the USA and the rest of the world were compared and insights drawn to inform this study. The role of the IOSCO code as an overarching international regulatory framework for CRAs was reviewed leading to the identification of regulatory gaps. The regulatory gaps on the oversight of CRAs, particularly in the EU were highlighted as a concern for academics and practitioners alike who called for active regulation of CRAs. Calls for regulation of CRAs were further heightened by the alleged role of CRAs in various corporate collapses and financial crises where CRAs allegedly failed to provide timely and accurate ratings. The 2007-8 global financial crisis was said to have triggered active regulatory initiatives by the European Commission, culminating in the promulgation of regulation No. 1060/2009.

Despite the EC CRA regulations coming in to address previously identified market problems, it was noted that they were met with criticism from those who argued that the regulations would likely do more harm than good to the securities market; that the regulations had not been well thought-through and that the regulations were limited in scope. This raised questions on whether such concerns were shared by market participants working in or around credit ratings and if so, what they perceived to be the specific impacts of the EC regulations as well as what alternative approaches they envisaged could address the identified problems in the ratings market. As yet, there have not been any empirical studies investigating the perceived impact of the EC credit rating agency regulations on the operations of the UK securities market. This study therefore sought to contribute to on-going debates in the ratings market by eliciting the views of practitioners who work with or around credit ratings on the possible impact of the EC credit rating agency regulations. With on-going debates and continued efforts to streamline the regulations so that they are fit for purpose, this study provided useful insights to identify areas that practitioners considered to be problematic as well as possible remedies for the identified problems. The next chapter discusses the study design and the study's methodological issues.

Chapter Five:

Methodology

5.0 Introduction

This chapter outlines the research design employed in the study, linking the chosen design to previous studies carried out in the area of credit rating agencies, credit ratings and securities regulation in general. After setting out the study parameters and requisite rationale, the chapter then considers possible limitations of the chosen approach and implications for the study. The section below explores previous studies carried out to investigate different aspects of credit rating agencies and credit ratings, considering their methodological and theoretical approaches and how this study builds on them.

5.1 Previous research approaches in credit rating studies

The majority of previous studies investigating credit rating agencies and credit ratings have largely adopted an economic perspective, in particular, analysing the efficacy of ratings, focusing on agency relationships and regulatory implications for the ratings industry. Methods previously adopted have tended to take a statistical analysis approach employing such techniques as ordinary least squares (OLS) or regression (Fisher, 1959; Horrigan, 1966; West, 1970); artificial intelligence techniques for rating predictions (Ahn & Kim, 2011); probit models (Kaplan & Urwitz, 1979); time series forecasting employing neural networks (Atiya, 2001; Singleton & Surkan, 1995) and support vector machine techniques (Chen & Shih, 2006; Huang, Chen, Hsu, Chen, & Wu, 2004) among others.

Researchers in previous studies largely took deductivist, quantitative approaches in the majority of cases. However, considering the fact that ratings are not solely numerical hard data, but rather, comprise subjective analyst judgments as well (Lehmann, 2003), the softer, behavioural view of credit rating issues also deserves exploration. Indeed, Frost (2007) argued that most of the criticisms levelled against CRAs were based on subjective conjectures which were difficult to prove and suggested that researchers from the accounting domain could add more insights particularly on financial market intermediation, auditing and disclosure among other issues. Similarly, Lawson (2009) lamented the dearth of comprehensive, contextual methodological approaches in understanding the social origins of the global financial crisis.

He argued that most studies attempting to frame the crisis were previously more inclined to "mathematical deductivist models" (p.759) which unfortunately did not sufficiently delve deep enough into the more insightful descriptive and behavioural backgrounds of participants in the securities market. Consequently, attempts to succinctly capture the behavioural causes of the crisis were said to have been thwarted by somewhat narrow, deductivist conceptualisations of securities market relationships (Colander et al., 2009). This posed a theoretical bottleneck because in an attempt to formulate conceptual solutions to the financial crisis, the origins, scope and dynamics of the crisis have to be accurately identified. This calls for comprehensive frameworks that simulate the inherent relationships and influences at play. So far, this has not been the case. There is an increasing number of authors who cite the 2007-8 crisis as a moral and ethical failure caused by greed (Dhiman, 2008; Greycourt, 2008; Lewis et al., 2010; Othman et al., 2010) or as a governance failure (Johansson, 2010). It is therefore key to examine this topic from broader, alternative theoretical perspectives so as to get a richer alternative view. There is therefore a compelling need for a social science approach to studying the financial crisis, its causes and possible solutions. In particular, rating agencies and their ratings present a worthy study area that needs to be looked at from all possible angles owing to their alleged contribution to the 2007-8 global financial crisis (Hunt, 2009a; Partnoy, 1999; White, 2009).

Despite impact assessments and consultations carried out prior to the enactment of the European Commission regulations, there were fears that the resultant EC regulations were narrow in scope (Utzig, 2010); that they would likely have unintended consequences (Lynch, 2009); that they did not comprehensively address the problems inherent in the ratings industry (Calomiris, 2009); that they were politically-motivated (Posner, 2010) and that they were reactive (Sy, 2009; Tichy, 2011). This raised questions on whether regulations (in general) and the EC regulations (specifically) were an appropriate response to the issues facing the industry after all (Mollers, 2009). A social science investigation of market participants would therefore be helpful in several ways. Firstly, it would empirically evaluate market participants' views on the impact of the regulations and contribute to previous consultation efforts in this area.

Secondly, the approach would consider more insightful behavioural issues surrounding the quantitative data and thus contribute to a more holistic appraisal of issues in credit ratings. As the regulations were still relatively new at the time of conducting this study, investigating market participants' perspectives on the regulatory initiatives was a new study area suggesting an exploratory approach. Results from this study will therefore form an important benchmark against which further future studies can be carried out to investigate the shift of issues around credit ratings over time. Before discussing the approaches adopted in this study, section 5.2 gives an overview of typical methodological considerations in social research in general, together with implications on study design.

5.2 Study design considerations in social research

Methodology, as distinct from method, refers to broader considerations around the adopted study approaches, tools or techniques. This also covers the implications of the chosen approach and possible limitations in achieving the study aims. Methods on the other hand are the specific implements or tools employed to collect data (Barbour, 2008). According to Crotty (1998), there is a distinction between a theoretical perspective, methodology, epistemology and method. Despite the cited differences, all these are interlinked and inform each other. Typically, the idealised view is that the researcher's philosophical position sets the context for the methodology, which in turn shapes the chosen research methods. In contrast to the above however, in reality, the tendency is to start with methods, leading to methodology and subsequently to the philosophical framework and finally to the epistemology underpinning the study, (Creswell, 1994; Crotty, 1998). Section 5.3 below covers the philosophy of research and its influence on study design.

5.3 Philosophy of research

The philosophy of research encapsulates ways of knowing and assumptions made about the world together with knowledge creation, (Hughes, 1987). Philosophy underpins any research process or tools used to generate knowledge. It is a key consideration for clarifying parameters within which a study is conceived and carried out. According to Burrell & Morgan (1979) social science is viewed explicitly or implicitly through four sets of assumptions looking at ontology, epistemology, human nature and methodology.

On the same subject, Hughes (1987) identified a number of different philosophical approaches to social research including realism, empiricism, positivism, idealism, rationalism, objectivism, subjectivism and interpretivism among others. Each philosophical position has implications on knowledge construction particularly with regards to each position's corresponding assumptions of the relationships between the knower and the known (Hughes & Sharrock, 1990). Definitions of research issues within each philosophical position therefore have to be based on the tenets of that philosophical position. The implication of situating studies within the respective philosophical positions has an important role in determining the validity and consistency of the conclusions made (Hughes, 1987; Uddin & Hamiduzzaman, 2009). The section below discusses the role of ontology, epistemology and methodology in designing social research studies.

5.3.1 The role of ontology, epistemology and methodology

Ontology covers human assumptions about the reality of phenomena under investigation. This looks at whether the phenomena are objective, i.e. external and independent of the inquirer; or subjective, i.e. "a product of individual cognition" (Burrell & Morgan, 1979, p.1). Epistemology on the other hand concerns itself with the nature of knowledge, its generation and how it can be shared as well as the grounds on which truth and falsehoods are constructed. Underlying ontological and epistemological views and assumptions is human nature. This underpins man's relationship and role with / and in the environment, i.e. whether man is 'the' creator determining what happens around him, (determinism) and / or whether man is merely responding to what happens around him i.e. controlled by the external environment (Seale, 2004). In social science settings, the intricate blend of the above assumptions influence what methodology is adopted in the quest for knowledge. The result of each adopted option in turn gives a plethora of potential interpretations open to social scientists.

From a deterministic perspective, methodology would concern itself with the articulation of concepts being investigated, how they are measured, and the assumptions underpinning them. From a voluntarism view of social reality, social inquiry focuses on the different human conceptions and the influences around people. This emphasises the interpretation of reality in context, acknowledging the relativistic orientation of social reality (Blaikie, 2000).

By virtue of its relativistic nature, this assumption falsifies the concept of falsity, i.e. there is no 'wrong' but there is 'different', depending on the viewer's contextual view (Holden & Lynch, 2004). A deeper analysis of this view validates people's subjective perspectives as contextually-legitimate in explaining social reality, i.e. reality is what makes sense as explained by one's context and inclination at a point in time. The focus changes from a generalised view to a substantive one where context and setting influence the understanding when making sense of one's reality.

5.3.2 Validity in social research

In determining the validity of knowledge generation in social science, the robustness or plausibility of the chosen methodology is considered in relation to the underpinning paradigms, ontological and epistemological traditions within which the methodology sits. This largely stems from the different possible approaches to studying social phenomena and the different interpretations that can be derived from studying the same phenomena but from different paradigms (Blaikie, 1993; Denzin & Lincoln, 2003; Hatch & Cunliffe, 1997). The understanding of the broader context of the study helps to expose the possible biases (James & Vinnicombe, 2002) as well as justify the methodological choices and preferences adopted in the approach of the study (Blaikie, 2000).

5.3.3 Philosophical paradigm adopted in this study

A paradigm can be viewed as a "basic belief system or world view that guides the investigation" (Guba & Lincoln, 1994, p.105). It consists of "..the general theoretical assumptions and laws, and techniques for their application that the members of a particular scientific community adopt" (Chalmers, 1982, p.90) and embodies the assumptions, concepts and frameworks used to construct knowledge as discussed above.

This study is situated within a qualitative, naturalistic setting, (Hammersley, 1999) investigating UK-based market participants' perceptions of the impact of the European Commission credit rating regulations on the UK credit rating and /or securities market. The adoption of an exploratory, qualitative approach was driven largely by the lack of existing studies investigating market participants' reactions to the relatively new EC regulatory phenomenon.

The area is therefore new, with the regulations only having been gazetted in 2009 for implementation by the end of 2010. In this respect, rather than pre-defining a prescribed detailed focus on the issues to be investigated, an exploratory qualitative approach allowed for "respondents to identify those issues which are salient for them and to explain how these impact on their daily lives,......" (Barbour, 2008, p.12). Initially, grounded theory was considered as both a theoretical framework and a methodology for guiding the design of the study. This approach was considered as it would allow for emergence of key themes from the collected data particularly as the study was exploratory in nature (Charmaz, 2006). On closer analysis, the prescriptive nature of grounded theory with regards to prior consultation of extant literature made it unsuitable for this study (Suddaby, 2006). This owed to the fact that in framing the questions, the study had to review extant literature as a way of identifying the topical issues relating to the regulation of CRAs in the EU. Further, the limited scope of this study made it difficult to develop new theory as is the aim of grounded theory.

5.3.4 The role and place of theory in qualitative research

It is not uncommon for studies of a qualitative nature to be exploratory, particularly in new research areas (Stebbins, 2001). In such cases, theory is brought in towards the end of the study to illuminate the findings. Theory therefore tends to be used "once we are in the business of attempting to shed light on the data we have generated" (Barbour, 2008, p.233). This view was endorsed by Creswell (1994, p.94-95) who postulated that:

> *"..in a qualitative study, one does not begin with a theory to test or verify. Instead, consistent with the inductive model of thinking, a theory may emerge during the data collection and analysis phase,…or be used relatively late in the research process as a basis for comparison with other theories"*

In contrast to the above view, Patton (1990) argued that theory should precede methodology and methods as "how you study the world determines what you learn about the world" (p.67). Merriam (1998) concurred with Patton (1990) adding that theory is the backbone or pillar of the study, supporting the entire study from the conception of what data to look for, through to the interpretation of the findings. Viewed from Merriam (1998)'s standpoint, the theoretical frame stems from the extant literature surrounding the study.

It precedes the data collection and analysis stages to ensure that the study questions are guided by the relevant theoretical frame and extant literature in the relevant study area. The above view is consistent with the views of Miles & Huberman (1984) who acknowledged that researchers approach the field with some initial ideas that help delineate and scope the study. Pointedly though, Miles & Huberman (1994) referred to 'ideas' as opposed to 'theory' and the two clearly have different connotations. Consequently, study findings need to be tested against the initial theory either to confirm or disprove it. This approach poses challenges in studies investigating new phenomena where there may be little prior research, requiring researchers to adopt other parallel approaches or break new ground.

Although regulatory studies are not new per se, regulatory studies specifically investigating European CRA regulations are a new development. Exploratory studies therefore go against the views expressed above (Merriam, 1998; Miles & Huberman, 1994; Patton, 1990) as they traverse virgin territory where there may be paucity of theory. Instead, theory in such studies tends to be employed to explain the findings towards the close of the study (Barbour, 2008; Creswell, 1994).

5.3.5 The role and place of theory in this study

This study investigated market participants' views on the perceived impact of the CRA regulations on the UK credit ratings and / or securities market. The focus on the EC regulatory impact is a new area with not much previous empirical investigations of UK-based market participants' perceptions of the impact of the EC CRA regulations on UK ratings market operations. Consequently, the adopted approach sought to use theory to interpret the findings as opposed to using theory as a philosophical frame to design the study. The researcher acknowledged the role of extant literature covering broader aspects of credit rating agencies and credit ratings. This literature though broad, helped to identify sound philosophical underpinnings which in turn enabled the framing of the study, conception of what questions to ask, choice of research methods as well as analysis and interpretation approaches adopted to manage the study findings (Bentz & Shapiro, 1998).

Pursuant to the Creswell (1994) and Barbour (2008)'s approaches discussed earlier, this study did not prescribe a theoretical stance in advance. Rather, once data had been generated and analysed, relevant theoretical frameworks were subsequently employed to better shed light on the resultant findings. Because of the exploratory nature of the study, a qualitative approach was deemed appropriate to elicit detailed views from study participants.

5.3.6 Qualitative research approach

A qualitative research approach allows for rich and holistic data capable of revealing complexity within the study area (Miles & Huberman, 1994). Further, this approach is "fundamentally well-suited for locating meanings people place on the events, processes and structures of their lives; their perceptions, assumptions, prejudgements, presuppositions" (Van Manen, 1977, p.207).

The study adopted a relativist ontological perspective (Tan, 2002), acknowledging the potentially varied perceptions of market participants with regards to the impact of the EC regulations on the operations of the UK securities market. The goal therefore was to investigate the contextual implications of the regulations to the different participant groups. Semi-structured interviews were selected as the most appropriate data collection tool as they offered a combination of flexibility allowing participants to bring out issues perceived to be important, but also offered the researcher an opportunity to steer the conversation while probing further for clarifications.

5.4 Background on research participants

Study participants were drawn from 4 groups comprising professionals who work closely with or around credit ratings. The first group of participants was made of issuers, representing the rated institutions that borrow money and pay for credit ratings. The second group of participants were drawn from institutional investors. Although they do not pay for ratings or influence their generation, institutional investors are the major consumers of credit ratings whose views on the new regulations will be key in this study. A further group of Other Interested Parties (OIPs) working closely with rating agencies was interviewed.

This category encompassed researchers, journalists and retirees from the investment, issuing or regulation communities with an interest in rating agencies. Lastly, although CRAs were at the centre of the regulations, they were themselves not market participants but their views were deemed important in understanding the impact of the regulations to their operations. The following section gives more information on the study participant groups before discussing the sampling approach and how the participants were recruited.

5.4.1 Issuers

Issuers formed the largest group of respondents in the study and comprised senior treasury officials (ranging from senior analyst to director level) drawn from various industries as shown in the table below. Participants were largely male, with only three females, all drawn from British-based issuing organisations.

Table 18: Breakdown of issuer participants

Participant Code	Industry / Sector	Position in Company
IS1	Gas / Electricity / Water	Senior Analyst
IS2	Construction / Building / Civil Engineering	Head of Treasury
IS3	Construction / Building / Civil Engineering	Group Treasurer
IS4	Engineering / Heavy Machinery	Group Treasurer
IS5	Financial Services	Treasury Manager
IS6	Food / Drink / Tobacco	Senior Analyst
IS7	Gas / Electricity / Water	Deputy Treasurer
IS8	Tobacco	Group Treasurer / Retired
IS9	Gas / Electricity / Water	Deputy Treasurer
IS10	Tobacco / Financial Services	Treasury Consultant

Source: Compiled by author

5.4.2 Institutional investors

Representatives from institutional investors consisted of a total of 9 participants, forming the second largest group of interviewees in the study. Participants were drawn from financial services, manufacturing, local government, pension funds and pharmaceutical industries. All participants were at director level in their respective organisations and had a good strategic view of issues involving ratings and the EC regulations. Seven participants were male, with only two females. A summary of participants' profiles is given in the table below.

Table 19: Breakdown of institutional investor participants

Participant Code	Industry / Sector	Position in Company
IN1	Financial Services / Pension Funds	Director level
IN2	Financial Services / Cash Management	Director level
IN3	Financial Services	Director level
IN4	Pharmaceuticals	Director level
IN5	Local Gvt / Gvt Agencies	Director level
IN6	Financial Services	Assistant Director
IN7	Manufacturing	Director level
IN8	Financial Services	Director level
IN9	Financial Services	Director level

Source: Compiled by author

5.4.3 Other Interested Parties (OIPs)

This group comprised 5 senior professionals either working largely in, or who had previously worked in professional services or in advisory functions, working closely with credit ratings and or credit rating agencies. This group also included any individuals who for whatever reason used credit ratings in making decisions (Duff & Einig, 2009b). Two of the participants had worked in regulatory capacities before and thus had good internal and external views of the securities in general and credit ratings regulatory issues. Of the 5 participants, 4 were male, with only one female. It was envisaged that the views from this group of participants would be key in offering an objective perspective as they were and are not directly involved in ratings themselves either in an issuing or investing capacity. The table below gives an overview of the participants in this category, together with the industry sectors represented.

Table 20: Overview of OIP Participants

Participant Code	Industry / Sector	Position in Company
OP1	Financial Services	Director level
OP2	Advisory / Professional Services	Director level
OP3	Professional Services	Director level
OP4	Professional Services	Director level
OP5	Professional Services	Director level

Source: Compiled by author

5.4.4 Credit Rating Agencies, (CRAs)

The rating agency sector is dominated by a few players in an oligopolistic fashion and it could be easy to identify individuals if detailed profiles were given. To protect the identity of the participants, their profiles and the details of their organisations were obscured. Out of the 6 participants in this category, the majority (4) were male, with only 2 females. The table below gives an overview of the participants.

Table 21: Overview of CRA participants

Participant Code	Industry / Sector	Position in Company
CR1	Credit Ratings	Assistant Director
CR2	Credit Ratings	Director
CR3	Credit Ratings	Senior Analyst
CR4	Credit Ratings	Senior Analyst
CR5	Credit Ratings	Senior Executive
CR6	Credit Ratings	Senior Director

Source: Compiled by author

The following section discusses the sampling approach adopted to recruit participants for the study together with justifications for the chosen approach.

5.5 Sampling approach adopted in this study

The study initially used a purposive non-probability sampling approach (Roulston, 2010). Participants were specifically selected for their involvement and knowledge of credit ratings, an area comprising a limited and specialised population. According to Miles & Huberman (1994) samples in qualitative research may not be predefined but instead, may change as the study evolves to reflect the emergent issues and further sources of relevant information.

Because of the closed nature of the rating industry, a purposive approach was adopted for the initial stages of the study, using a list of participants drawn from members of the Association of Corporate Treasurers (ACT). During the interviews, each of the participants was asked for further relevant contacts in the industry, consistent with the snowball sampling approach (Biemacki & Waldorf, 1981; Goodman, 1961). This owed to the specialised nature of the credit rating subject, which has a limited network of professionals who have dealings with the credit rating industry. The purposive and snowballing approaches are discussed in more detail below.

5.5.1 Purposive and snowball sampling

The initial list of study participants was provided courtesy of the Association of Corporate Treasurers who allowed access to their membership database. The ACT is a professional body representing treasury professionals. As the membership database contained thousands of entries, potential interviewees were purposively selected based on the following criteria:

1. Only members of the ACT working group were considered. The ACT Working Group actively reviews the proposed European Commission credit rating regulatory reforms, recommending appropriate responses to and by the ACT.
2. Only those members who had an expressed interest in the area of credit ratings were selected. Profiles of ACT Working Group members highlight members' interests as well as their willingness to participate in studies involving credit ratings, making the members an ideal sample for this study.

Invitation requests were sent via email to a total of 35 contacts. A total of 23 participants responded positively and out of these, 19 were successfully interviewed. During the interviews, the researcher adopted a snowball sampling approach, requesting each interviewed participant to volunteer further potential interviewees who fit the criteria described in section 5.4 (Overview of research participants). This approach was taken particularly as some of the participants pointed out that there could be other good sources of information who did not necessarily subscribe to the ACT. Using the snowball approach, a further 21 contacts were generated. Of the 21, 11 were subsequently interviewed, bringing the total interviewees to 30.

Borrowing from some grounded theory sampling techniques, no sample size was defined beforehand. Instead, the ultimate sample size was a result of theoretical saturation (Charmaz, 2006; Riley, 1996). Issues brought up in interviews were explored in successive interviews using the constant comparative method (Barbour, 2008) until they were exhausted. When no new issues came up in the last successive interviews, saturation was deemed to have been reached and the interviews were concluded. At the conclusion of the data collection exercise, a total of 30 participants had been interviewed broken down into the categories discussed in 5.4 above.

Notwithstanding the fact that participants volunteered to be contacted for further clarifications, out of a total of 15 email requests sent out as follow-up to the interviews, only two responses were received from the participants, despite earlier promises that they would respond to emerging questions. The next section briefly discusses the procedures taken to recruit study participants as well as send out interview requests.

5.5.2 Recruitment of participants

For the first batch of 19 interviewees provided courtesy of the ACT member directory, email addresses and telephone numbers were made available in members' profiles alongside their interests and willingness to participate in studies involving credit rating agencies. The researcher was granted access to the online member directory and asked to contact only members of the Working Group who had expressed an interest in the study of rating agencies. Interview requests were emailed to participants together with a Participant Information sheet (see Appendix 1) detailing the research brief, interview details together with a request for an interview appointment.

Potential participants were given an outline of their expected contribution and a rationale of why they were selected for the study. Contacts were given flexibility to nominate dates and times convenient to them (with some dates suggested by the researcher). An email reminder was subsequently sent out again 2 weeks after the initial email and again 2 weeks after the second email reminder. If there were no responses received after the second reminder, the relevant names were crossed out of the potential list. For the snowballed 11 participants, interview requests giving detailed information about the study were sent out using email addresses provided by their referees. Reminders were sent out as in the first batch of participants discussed above. In all cases, participants who volunteered to be interviewed mostly asked to be interviewed at their work premises either in their offices or in canteens or meeting rooms. In a few cases, interviews were held in public coffee houses or restaurants. During the interviews, the interviewer reassured all participants that results would be made anonymous to protect participants' identities. Participants signed a consent form for the interviews to be recorded.

5.5.3 Rationale of the sampling approach

In a study carried out prior to the 2007-8 global financial crisis and the subsequent regulations, Einig (2008) conducted semi-structured interviews of 16 participants drawn from institutional investors, issuers, OIPs and CRA representatives. As part of recommendations for further research, the author indicated that further studies, particularly after the 2007-8 crisis would be helpful in shedding light on evolving participant perceptions towards the regulations. This study follows on from the Einig (2008) study. Consequently, a similar participant sample was used for consistency. The advantage of the above sample is that it comprised people likely to be knowledgeable about ratings as well as interested in the issue of credit rating agency regulations owing to their proximity to the regulatory issues.

5.5.4 Potential limitations of the sampling approach

From a sampling viewpoint, the ACT Working group, by its very nature is self-selected and may have a possible bias depending on their mandate in the ACT. There is also the limitation that participants who were not members of the ACT (or were not known to ACT members) were automatically excluded and may have had different contributions to make. Having worked on previous research studies involving credit ratings and possibly, the EC regulations, ACT Working group members may have been primed in the area with ready responses on rating agency subjects.

Notwithstanding the above possible limitations, the diverse nature of the participant categories represented by the group (i.e. investors, issuers, CRAs, OIPs) suggested that any possible collective bias would have been diluted as each represented group was likely to interpret and be affected by the regulations differently. A unanimous collective view was therefore not expected from all the interviewed ACT Working Group members. Section 0 outlines the data collection process in more detail.

5.6 Data collection

Once appointments were secured, actual interviews lasted on average, between 30 minutes and 1 hour and were primarily held at participants' places of work or public places such as restaurants agreed to by the interviewer and interviewee. A few interviews had to be conducted via the phone at the request of the interviewees. Interviews opened with introductions from the interviewer, thanking participants for their time and advising participants of the way their data would be handled, in line with the university's Ethics Policies and in accordance with the Data Protection Act (1998). Permission was sought from participants to audio record the interviews and as proof of consent, participants were asked to sign a disclaimer consenting to participating in the interview and for the interview to be audio-recorded. A copy of the form is shown in Appendix 2. Interviews followed a semi-structured format as discussed in section 5.6.1.

5.6.1 Semi-structured interviews

The exploratory nature of the study required a flexible and open data collection technique that would allow for participants to guide the discussion towards issues deemed to be key in the study area (Stebbins, 2001). Semi-structured interviews were chosen ahead of other tools as they allowed for an insightful exploration of participants' responses as well as uncovering their reasoning behind the expressed views on the perceived impact of the EC regulations (Kvale, 1983). Further, because of the participant groups' diverse backgrounds, it was deemed important to adapt the interviews to respond to each group and individual needs.

Structured interviews were deemed restrictive and inappropriate in a new area where the participants knew more about the research subject than the researcher and thus needed the flexibility to take the lead, with the researcher acting as a facilitator (Fontana & Frey, 2000). The researcher used an interview schedule with broad topics to steer the discussion. This is discussed in 5.6.2 below and presented in Appendix 3. During the interviews, participants had the leeway to emphasise on issues that they felt were pertinent to the discussion and in particular, to their own organisations and the industry. This owed to the exploratory nature of the study but posed challenges in the analysis stage as some of the emerging issues could not be checked back with previous participants.

5.6.2 Interview schedule

An interview schedule with broad open-ended topics was designed to steer the discussion. The open-ended nature of the guide allowed for elucidation of issues by interviewees (Barbour, 2008). The guide was informed by extant literature in the area of credit ratings and regulation, covering broad topics such as: what participants perceived to be the key issues in the credit ratings market and whether such issues were receiving appropriate focus in the EC regulatory initiatives; perceived causes of the crisis; perceived regulation drivers; legacy problems in the credit ratings industry; perceived impact of the EC regulations (costs vs. benefits); perceived unintended consequences; regulators' perceived competence; views towards the mooted EU-based CRA together with possible alternative CRA revenue models; the nature of the EC regulations and perceived changes in the ratings industry post the 2007-8 crisis and the enactment of the EC regulations.

There were areas common across all participant groups, while others related exclusively to particular participant groups. The common focal areas allowed for comparability of views across the different participant groups but when it came to the specific issues, these could not be compared across the different groups. Einig (2008) employed a similar approach in designing interview questions posed to 16 participants drawn from the same participant groups as above. The main advantage of using a similar approach is to make comparisons between the findings of the two studies.

5.6.3 Interview format

The interviews opened with "less threatening questions" (Barbour, 2008, p.115), asking participants to give their backgrounds and involvement with credit ratings. This included such things as an overview of their work, responsibilities and time in the company or industry. Once participants were settled and comfortable, subsequent questions focused on issues around the EC regulations as highlighted in section 5.6.2 above. The format and order of the questions was not strictly adhered to, allowing participants to steer the conversation towards what they deemed important within the broad research focus. Prompts were occasionally used to probe for deeper insights and steer the interviews to keep them in focus.

5.7 Limitations of the data collection approach

According to Zikmund (2003) personal interviews can be influenced by interpersonal dynamics between the interviewer and interviewees. With the interviewer dealing with highly experienced senior executives considered to be experts in their field, it is possible that interviewees may have regarded some questions as naive, possibly clouding their responses. Further, with participants being experts who regularly engaged with the subject of credit ratings, their responses may have been mechanistic, rehearsed views that may indicate the official group line as opposed to genuine, spontaneous reactions shared by their respective industry groups. To mitigate the above limitations, selected participants were briefed on why they had been chosen together with the contribution expected from them, thereby acknowledging their expertise in the study.

The nature of semi-structured interviews meant that the flow and format of the interviews was different with each participant owing to the open-ended questioning approach. This resulted in somewhat varied responses, with some participants generously volunteering lengthy answers and having to be nudged to maintain some focus, while others gave very minimal responses and had to be probed in an attempt to get more input as well as seek clarifications on some of their contributions. On three different occasions during the study, participants started volunteering data well before the interviews started (examples included conversations on the way from collecting the researcher at reception; while ordering coffee as well as while in the lift on the way to the interview venue). On all these occasions, the researcher had not yet had a chance to take out recording equipment or interview schedules. However, on each of these occasions, once the party had sat down, the researcher would request for participants to recap on some of the issues referred to earlier in the unrecorded conversations.

It was noted that in all the three cases, participants were not as spontaneous and unrestrained as they had previously been. One participant was noted to say "*As I mentioned while we were on our way....*" refusing to give any further details of the previous unrecorded conversations. Some useful information was also proffered after the conclusion of the interviews while participants were accompanying the researcher to the lifts or escorting him out of the meeting venues.

These incidents raised questions on whether recording equipment ought to be left on until after the researcher had left the premises or whether such acts could have connotations on data confidentiality and wider ethical issues.

5.8 Parallels drawn from other studies

Due to the lack of literature around market participants' perceptions of credit rating agency regulations, this study borrowed insights from the audit literature. As discussed in section 2.6, credit ratings and the audit profession share a common heritage. Both professions play a crucial yet contested financial intermediation role, (Opp et al., 2012) and both professions have been implicated in failing to avert corporate collapses leading to incessant calls for them to be regulated. As audit literature had more coverage in the area of participants' perceptions towards regulation of the practice, insights from audit were drawn and inferences made to the credit rating area. Several studies were conducted, investigating the perceptions of different market players, (see for example Beattie, Brandt, & Fearnley, 1999; Dart, 2011; Houghton, Jubb, Kend, & Ng, 2011). Although these studies investigated investors' perceptions towards auditor independence, the principle of studying perceptions and reactions to a phenomenon such as auditor independence or the perceived impact of the EC credit rating agency regulations is important as it helps to understand the concerned participants' reactions towards the identified phenomena, giving indications of how such participants might cooperate with regulatory efforts. Dart (2011) surveyed UK-based investors to gauge their perceptions towards auditor independence. Auditors like rating agencies had issues of conflicts of interest and were also classed as information intermediaries or gatekeepers (Fleischer, 2010; Lombard, 2008). Therefore, insights from developments in the audit literature acted as useful comparators when studying CRAs.

5.9 Chapter summary

This chapter gave an overview of the key philosophical considerations underpinning social research studies in general and the approaches specifically adopted in this study. Philosophical assumptions were shown to be key in shaping the design, methodologies and specific research techniques adopted in the study.

The paucity of theory and background studies around market participants' perceptions of the relatively new EC regulations influenced the adoption of an exploratory study taking a qualitative approach. As the perceived impact of the EC regulations was likely to be contextually-framed, an interpretivist philosophical approach was deemed to be an ideal underpinning epistemological stance. As the area was specialist in nature, a qualitative approach was deemed necessary, employing semi-structured interviews to allow participants to steer the interview conversations towards issues perceived to be salient in the study area. A combination of purposive and snowballing sampling techniques was used to recruit study participants. Data collection techniques employed in the study were discussed and appraised. A rationale was given for adopting the selected methods. The next chapter offers an overview of data analysis in qualitative research before outlining the analysis approach adopted in this study.

Chapter Six:

Data Analysis

6.0 Introduction

This chapter outlines the data analysis approach adopted in this study, situating it within an interpretivist paradigm, taking a qualitative research approach. A rationale for the approach is given, highlighting the influences of the exploratory approach adopted in the methodology section. The chapter details the preparation of the data prior to analysis, covering the transcription of the audio-recordings into word documents to facilitate easier analysis. Due to the exploratory nature of the study, it was necessary that the analysis process involved deep immersion into the data to allow for insights to emerge directly from the data. In the process of analysing data, the researcher discovered a prevalent use of metaphors by study participants. Metaphor analysis was therefore adopted as a method of analysing and making sense of the data. To offer a holistic view of all the participants, non-metaphor data was also analysed and the results thereof aligned to the emerging metaphor categories. Section 6.1 below discusses qualitative data analysis in general before the chapter goes on to focus specifically on the metaphor analysis approach adopted in this study.

6.1 Background to data analysis in qualitative research

Data analysis in qualitative studies is still regarded as one of the most challenging steps in qualitative research studies as acknowledged by Miles & Huberman (1994, p.2)

> *"the most serious and central difficulty in the use of qualitative data is that methods of analysis are not well formulated...the analyst faced with a bank of qualitative data has very few guidelines for protection against self-delusion, let alone the presentation of unreliable or invalid conclusions to scientific or policy-making audiences..."*

The open nature of qualitative studies makes it difficult to hone in on study findings particularly for inexperienced researchers. This makes judging validity and reliability equally difficult. There are diverse opinions on the conduct of qualitative data analysis with some scholars arguing that it is impossible to arrive at sound conclusions within the realms of qualitative studies (Bruyn, 1966; Wolcott, 1992). On the other hand, there is a growing body of research highlighting an increasing acceptance of qualitative data in explaining social phenomena (Dey, 1993; Fielding & Fielding, 1986).

While traditionally, some scholars have pitted qualitative approaches against their quantitative counterparts (see for example Guba & Lincoln, 1994; Reichardt & Rallis, 1994; Mahoney & Goertz, 2006), it is important to highlight the interdependence and complementarity between quantitative (enumeration) approaches and qualitative (conceptualisation) orientations (Tashakkori & Teddlie, 1998). A combination of the two approaches provides for richer and more balanced research outcomes (Dey, 1993). Previously, quantitative studies were touted as more credible and scientifically robust compared to their qualitative counterparts (Labuschagne, 2003). Notwithstanding such claims, quantitative studies have their own weaknesses, probably more aptly captured in Reason & Rowan (1981) who argued that:

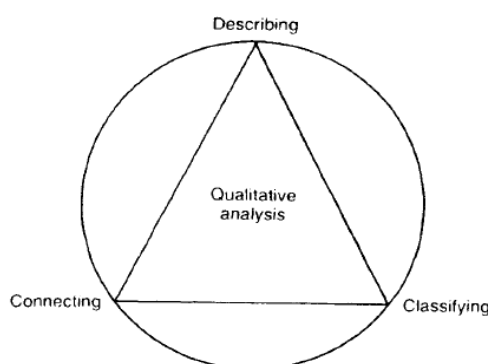
> *"There is too much measurement going on. Some things which are numerically precise are not true; and some things which are not numerical are true. Orthodox research produces results which are statistically significant but humanly insignificant; in human inquiry it is much better to be deeply interesting than accurately boring" (Reason & Rowan, 1981, p.xv)*

The above argument underscores the dangers inherent in quantitative studies and the generalisations that can potentially emanate from too much focus on numerical data, ignoring the more descriptive and perhaps more informative data around the numbers. Such rigid numerical conceptions can mask finer behavioural details between the figures. The suggestion by the authors was that richer and more explanatory data could be obtained via qualitative studies, complementing results of quantitative numerical data, rather than nullifying them.

6.1.1 Generic issues in qualitative data analysis

Dey (1993, p.31) defined analysis as ".. a process of resolving data into its constituent components, to reveal its characteristic elements and structure." In doing so, it is important to employ a rigorous procedure that gives a better understanding of the objects that the data refer to. Since the data is broken down and reconstituted into different forms through the sorting, coding and categorisation processes, the result may permit interpretations that were not immediately manifest in the original form of the data. Dey (1993) summarised the three iterative steps prevalent in the qualitative analysis of data (see Figure 8).

Figure 8: Iterative Processes in Data Analysis



Source: (Dey, 1993,p.32)

Figure 8 summarises the interrelated actions of describing the data, classifying the data into relevant groups or categories and establishing connections within and between data categories as well as developing intuitions to better understand what is happening in and across the data sets. The process suggests going back and forth in the data (Baptiste, 2001). This iterative process may involve initial categories or descriptions being revised in subsequent steps. Although various scholars have proposed frameworks which take slightly different steps for analysing qualitative data (Barbour, 2008; Creswell, 2002; Marshall & Rossman, 2006; Miles & Huberman, 1994), they all concur on the need to sort and code qualitative data before analysis and interpretation can be effectively carried out. The section below gives an overview of the preparation of the data prior to the analysis. Thereafter, Section 6.1.3 outlines the coding process which is key in analysing data.

6.1.2 Data preparation and sorting

In preparation for the analysis process, data has to be converted into text. This may involve transcribing from audio formats into word text. Transcribing data takes time and researchers need to take this into consideration when deciding how much data to collect (Oliver, Serovich, & Mason, 2005). While hiring out the data transcription process may seem economic and save time, some scholars advise researchers to do the transcription themselves so as to start developing a relationship with the data (see for example Merriam, 2009). Once data has been transcribed, researchers can then start breaking it down and identifying unique themes which are aptly labelled. This is achieved through the coding process which is discussed below.

6.1.3 Coding

Coding is a key part in the data analysis process within qualitative environments. David & Sutton (2011, p.339) defined coding as "the process of applying codes to chunks of text so that those chunks can be interlinked to highlight similarities and differences within and between the texts." Coding helps to flag emerging and pertinent issues from the transcripts and is instrumental in mapping and classifying relationships across identified issues from different participants.

According to Dey (1993) data classification involves conceptually breaking the data into bits, grouping the bits together and rebuilding the bits into relevant categories which may throw up new meanings. The new bits of data are assigned codes to identify them. As David & Sutton (2011) suggest, codes can be words, phrases or sentences used by the interview participants, (manifest or in vivo codes) –or they may be generated by the researcher to succinctly capture the essence of the relevant chunks of data (latent codes). The authors further identify codes "drawn from the language of the researcher's theoretical background" (David & Sutton, 2011, p.343) and relating participants' views to broader issues in the research realm. These codes, commonly known as sociological codes, are generated by the researcher who compares participants' views to issues raised in the broader subject literature in a way that narrows down and identifies commonalities (see for example Coffey & Atkinson, 1996). There is a danger though of rushing too quickly to conclusions without exploring issues to sufficiently critical depths, while the opposite is true of the researcher getting lost in myriads of multiple meanings (David & Sutton, 2011). Thorough, considered tests and comparisons of emerging themes have to be carried out to ensure a reliable study outcome. The coding process is a reductive process, allowing for the identifcation and testing of the strengths of emerging issues or themes.

6.2 Data analysis approach adopted in this study

The data for this study was gathered using audio-recorded interviews which were later transcribed by the researcher into word formats. Initially, a thematic qualitative data analysis approach was adopted to analyse data. The approach followed three concurrent stages identified by Miles & Huberman (1994) comprising data reduction, data display and conclusion-drawing.

Within the data reduction stage, the study followed the Creswell (2002) 5-step process covering (i) initially reading through the data, (ii) identifying segments of related data sets, (iii) labelling the identified segments to create categories, (iv) the reduction of overlaps and code redundancy as well as (v) the creation of a model incorporating the emerging categories. This analysis approach offered a framework for using participants' data to generate codes.

During the initial reading of the data and identification of segments, the researcher noticed a prevalence of metaphors used by participants. The rest of the data scripts were subsequently scanned to see if there was a consistent use of metaphors. Upon establishment of the consistent use of metaphors by the majority of participants, a decision was taken to adopt metaphor analysis as the method for analysing data in this study. The metaphors offered a more insightful perspective on participants' perceptions embedded in their language. To ensure that those participants who did not use metaphors still had their views considered, data analysis was then designed to follow two approaches; the metaphor analysis approach as well as a generic qualitative data analysis approach to capture participants' perceptions from the non-metaphor data. These two approaches were used to corroborate each other. The ensuing sections introduce metaphor analysis and explore its use in this study.

6.3 Background to metaphor analysis

While metaphor analysis is both a conceptual theory and a method (see for example Moser, 2000), this study adopted it as a method of analysing data. A metaphor can be defined as "a mapping of entities, structures and relations from one domain (called the 'source') onto a different domain (referred to as the 'target')" (Cornelissen & Kafouros, 2008, p.2). According to Llewelyn (2003), human conception of the world is encapsulated in metaphors, which are used as embodiments or visualisations of reality. They help human beings make sense of, and relate to abstract concepts. This view reaffirms Lakoff & Johnson (1980)'s seminal claim that metaphors are what "we live by."

Etymologically, the word 'metaphor' derives from the Greek "meta-pherein" translated as "to transfer" or bring over (McGlone, 2007). This suggests that meanings are transferred from source objects to explain target objects which in reality may be very different (Cornelissen & Kafouros, 2008).

This approach is helpful in explaining abstract phenomena. According to Aspin (1984) all languages have different metaphors embedded within their structure and in Lakoff & Johnson (1980; 1981)'s view, metaphors are the basic building blocks of interpreting and understanding abstract phenomena. Metaphors allow for meanings of obscure, abstract or unfamiliar phenomena to be explained using the analogy of other more familiar but different phenomena through imaging or picturing (Morgan, 1980). Morgan (1980; 1983) further highlighted the importance of metaphors in vividly explaining complex and abstract organisational phenomena which would ordinarily be difficult to understand. Use of metaphors in this instance induces new insights and inferences that may not have been imagined or envisaged before.

Morgan (1980; 1983) further argued that metaphors employing images of machines, (see for example Baum & Rowley (2002)) human beings, evolution or even politics help us to understand abstract organisational issues more vividly, using domains that are closer to our day to day images. By visualising abstract phenomena as machines for example, we seek solutions to machine-related problems and ways of operating them to bring about efficiency. This parallel approach may induce useful insights which when extrapolated back to human fields, conjures solutions that would not have been imagined before.

Metaphor analysis allows for the mirroring of reality through chosen metaphors (Wittink, 2011) and utilises "people's words as a source of data" (Billups, 2011, p.23). Metaphors allow for phenomena to be studied and understood from a number of different viewpoints. They help overcome the difficulties of explaining abstract phenomena (Ortony, 1975). They can be employed to signify underlying meanings of phenomena incorporating language and thought (Skorczynska, 2001). As metaphors can be understood differently by different people, their use in transposing meanings must allow for shared understanding (Inns & Jones, 1996). Metaphors are only as good as their ability to explain phenomena. Lakoff & Johnson (1980) asserted that metaphors are more cognitive than linguistic, meaning that language expressions in daily use embody much deeper conceptual frames embedded in metaphors. Metaphors therefore transcend linguistic depictions of reality and are a mode of thought (Mangham, 1996).

Metaphors symbolise the anchorage of human experiences of the world and "form the foundation of our conceptual systems" (Llewelyn, 2003, p.688). Consequently, metaphor analysis has the potential to provide new and deeper perspectives to data as will be seen through the analysis conducted in this study.

6.4 Metaphor analysis in business and management

Whereas Bourgeois & Pinder (1983) argued that metaphor use in management and organisational studies was inappropriate, there is evidence that metaphor use has gained steady recognition in this area (see Table 22 for a selection of studies employing metaphors in management and organisational studies). Notwithstanding the above, there is need for more empirical studies employing use of metaphors in organisational and management settings (Cornelissen, Oswick, Christensen, & Phillips, 2008; Oswick & Grant, 1996). This owes to the power of metaphors in vividly depicting phenomena and invoking exploration of possible alternative, conceptualisations of solutions to organisational problems.

The choice of metaphors used in management and organisational situations demonstrates the way participants conceptualise the situations and challenges facing them. An investigation of metaphor use therefore helps to shed more light on, and enhances the understanding of managerial and organisational issues from a slightly different angle when compared to traditional management and organisational studies. The adoption of metaphor analysis in this study therefore partly responds to, and contributes to the call for more studies to employ use of metaphors in management and organisation studies (Cornelissen et al., 2008; Oswick & Grant, 1996).

The mapping of organisations into mechanistic images in the Taylorist era enabled conceptualisations of different approaches to organising work and ushered in new ways of driving efficiency never used or envisaged before. The depiction of organisations as machines conjured images of organisations as entities that could be primed, tuned and oiled to perform better. When translated back to work situations, it meant that staff could be organised through training programs to perform efficiently and consistently (perhaps an analogy to programming machines!).

In subsequent years, metaphors were used to better explain the mapping of organisational processes (Boland, 2001; Parker, Guthrie, & Gray, 1998); organisational culture (Borden et. al, 1998); the depiction of abstract organisational standards and practices (Page & Spira, 1999); personal attitudes towards given situations (Deacon, 2000); growth, dynamism and development (Mouritsen, Larsen, & Bukh, 2001) as well as organisational functions such as in Coffee (2006)'s conception of rating agencies as 'gatekeepers.'

In all the instances cited above, the metaphors were used to bring to the fore, new aspects of the projected phenomena, evoking new thoughts in understanding and dealing with such phenomena. The value of metaphors lies in their ability to go beneath the visible and the obvious, highlighting the underlying connections and contributing towards the generation of new inferences. Table 22 below summarises a selection of key studies employing metaphors in management and organisational studies.

Table 22: Selected examples of metaphor use in management and organisational studies

Author(s)	Study details
Boland & Greenberg (1988)	Investigated the effect of using different metaphors in organisational problem-solving situations. Concluded that when different metaphors were used in explaining organisation situations, study participants were able to conceptualise problems differently and propose varied requisite solutions.
Dunford & Palmer (1996b)	Investigated the use of metaphors in management literature on downsizing using data obtained from popular management journals over 3 years
Parker, Guthrie, & Gray (1998)	Used the 'gate keeping' metaphor to depict the stranglehold that senior academics had on decision-making processes pertaining to research quality in universities
Jaeggi, Faas, & Mruck (1998)	Adopted a framework which saw researchers firstly building a model then searching for metaphors which stood out in the research material and at odds with the developed framework
Borden et al (1998)	Employed the metaphor of 'men in white coats' vs. 'men in grey suits' when they studied scientists vs. management locked in warring contrasts of bureaucratic organisational processes.
Fogarty & Radcliffe (1999)	Used the metaphor of travel to capture the broad spreading of accountants' jurisdictions as they sought to expand the market for the accounting profession.
Page & Spira (1999)	Used the underwear metaphor to shed light on frameworks in financial reporting and accounting standard-setting, cleverly employing the use of a dialogue between a standard-setter and an academic.
Deacon (2000)	Conducted a market research study where participants gave descriptions of themselves and/or products in vivid metaphors of showbiz, fairy tales, colours and even musical pieces.
Mouritsen, Larsen & Bhuk (2001)	Employed the use of the tree metaphor to symbolize green, growth, survival, fruition and the need for constant pruning at Skandia
Christensen & Olson (2002)	Asked participants to use metaphoric images that reflected their attitudes and feelings towards identified products. As participants explained their feelings, new metaphors emerged, vividly illuminating participants' attitudes

Author(s)	Study details
Harvey (2002)	Employed the metaphor of Alice in Wonderland when conceptualising HRM practices in Africa compared to those of the West. Western managers, like Alice in Wonderland, found themselves faced with new and unfamiliar territory when crafting HR policies for African contexts, having to navigate and familiarise themselves with new cultural approaches to work settings.
Baum & Rowley (2002)	Metaphorically depicted organisations as machines, linking back to the Taylorist era of scientific management and efficiency
Skorczynska & Deignan (2006)	Analysed two corpora spanning twelve business journals covering 90,207 words between 1997 and 1998. Concluded that metaphor-use was different across the two domains
Amernic, Craig, & Tourish (2007)	Analysed the use of metaphors in letters written by the renowned CEO Jack Welch of General Electric to the company's shareholders
Cassell (2012)	Interviewed 25 Hackney carriage drivers to elicit their views on customer service interactions. Resultant responses were summarised into five metaphor themes
Cassese and Casini (2012)	Portrayed credit rating agencies as 'honey birds' a metaphor based on an African bird that signals to bee hunters the location of honey bees' nests.

Source: Compiled by author

The relevance of the above set of studies is that in each case of metaphor use, studied phenomena were depicted in unrelated conceptions, allowing for a fresh perspective when evaluating such phenomena. Similarly, an investigation of issues around the regulation of credit rating agencies using metaphors allows for this rather abstract subject to be depicted in images or conceptions that participants may find easier to relate to. Section 6.5 provides a more detailed discussion on metaphor analysis methods and approaches of analysing metaphors.

6.5 Metaphor analysis approaches

In analysing metaphors, Cassell & Lee (2012) identified two approaches. The first approach (the deductive approach) generates metaphors from outside the studied phenomena and imposes them on the studied organisational phenomena as a way of making sense thereof (see for example Huzzard, Gregory, & Scott, 2004; Marshak, 1993). The second approach (the inductive approach) on the other hand "involves identifying metaphors in the context of people's language-use and examining their uses, meanings and impacts" (Cornelissen, Oswick, Christensen, & Phillips, 2008, p.10). This study adopted the inductive approach, where metaphors were drawn directly from the study participants. According to Cassell & Lee (2012), an inductive metaphor analysis approach can take one of two options; (1) the researcher can purposefully elicit metaphors from the studied phenomena by directly inducing

participants to consciously give out the requisite metaphors or (2) metaphors can be gleaned from interview transcripts or other recorded excerpts containing participants' language. This study used the second approach where participants' interview transcripts were analysed and metaphors identified from the language used. This approach had an advantage in that the identified metaphors occurred naturally and were subconsciously volunteered by participants as opposed to being imposed on participants by the researcher. The identified metaphors were therefore participants' own conceptualisations of the studied phenomena and thus represented participants' own original visualisations of reality in relation to the credit rating agency regulations. They could therefore be said to accurately capture how such reality was internalised and communicated by the study participants.

According to Llewelyn (2003) metaphors form the first of the five levels of theorising steps. This is because metaphors help to 'ground' experience, drawing parallels with other familiar phenomena. Metaphors offer a simpler abstraction of concepts, to allow people to make connections between different entities, making sense of one while using conceptions of the more familiar other. This suggests that metaphors have the power to bring closer to reality, phenomena that may appear remote and abstract. Table 23 summarises the five levels of theorising as propounded by Llewelyn (2003).

Table 23: The place of metaphor in theorising

Level	Theory	Empirical Issues
One	Metaphor	'Micro' reasons, actions; social production
Two	Differentiation	Micro, social processes
Three	Concepts	'Meso' agency - how individuals make things happen through resources
Four	Settings	The social organisation of relationships between individuals, organisations and environments.
Five	Structures	Class, gender, power relations and the distribution of resources

Source: (Llewelyn, 2003, p.667)

The relevance of the above levels of theorisation to the current study is that the nature of credit rating agencies and their regulation is a somewhat specialist and abstract subject. According to Llewelyn (2003), such abstract phenomena may not easily be conceived beyond Level 3 (see Table 23).

Consequently, study participants used level one (metaphors) to make meanings of their understanding of issues around the regulation of credit rating agencies. Metaphors offer such practitioners a platform to vividly depict the issues facing their organisations or industry. Consequently, metaphors, despite, their low level theoretical position, stand well positioned to clearly convey market participants' perceptions towards regulatory changes emanating from the EC credit rating agency regulations.

Morgan (1980, 2006) provided another useful classification of organisational metaphors categorising them into eight broad groups which helped to organise metaphors used in business contexts. In the classification, organisations were depicted as "machines, organisms, brains, cultures, political systems, psychic prisons, flux and transformation, as well as instruments of domination" (Wittink, 2011, p.10). These conceptualisations help to view organisations in different contexts, invoking inferences that are relevant to each context and allowing for innovative approaches to generating various options to address organisational problems. This allows for organisational managers to step out of their traditional views and consider their realities in unfamiliar domains.

6.5.1 Identifying metaphors for analysis

According to Lakoff & Johnson (1980; 1999), the process of identifying metaphors encapsulates the search for words or phrases that meet the following three criteria:

1. The word or phrase has connotations beyond its literal meaning,
2. The literal meaning of the word or phrase is derived "from an area of sensoric or cultural experience (source area)" (Schmitt, 2005, p.371),
3. The meaning is mapped or transferred to a different, often abstract, target domain.

The identification of metaphors must be done in consideration of the metaphors' contextual usage. As McCloskey (1964, p.217) acknowledged "metaphorical statements taken in isolation can neither be thoroughly understood nor judged valid or invalid." This underscores the importance of relating metaphors to their contexts as a way of validating their use. Schmitt (2005) summarised the steps involved in identifying and analysing metaphors as follows:

1. Scanning the text to identify words / phrases that meet set criteria (as outlined above). Once identified, the metaphors and immediate texts explaining the metaphors are noted and recorded,

2. Identified metaphorical idioms are allocated to metaphorical concepts,

3. Metaphors are then grouped according to collective references and inferences made from the categories.

Further to the above, Cassell & Lee (2012) highlighted an 8-stage metaphorical analysis process as shown below:

Figure 9: Metaphor Analysis stages

Analysis stage	Description of the analysis
1	Identify instances of metaphorical language from the transcripts
2	Identify initial metaphorical categories and categorize instances into these categories
3	Collapse and elaborate metaphorical categories and their content
4	Categorization of instances by second author to enable checking
5	Produce agreed initial list of metaphorical categories (root metaphors) and their content
6	Reread transcripts in regard to the root metaphors
7	Reread the transcripts to look for shared entailments between the root metaphors
8	Produce analytic account of the two overarching metaphors and outline how they are related to the other metaphors

Adapted from Cassell and Lee (2012, p.256)

Essentially, the above eight stages relate to reading the interview transcripts initially to make sense of the context of participants' views; identification of metaphors; grouping of metaphors into related categories; re-reading the transcripts to place the identified categories into their contexts within the transcripts as well as drawing inferences from the results. Section 6.6 below discusses the specific approach adopted in this study.

6.6 Metaphor analysis procedure adopted in this study

Pursuant to Lakoff (1993)'s definition of metaphors discussed above, and Schmitt (2005)'s steps of identifying metaphors, the use of metaphors in this study involved initially reading through participants' transcripts to identify words or phrases used outside of their usual contexts to depict aspects of credit ratings or participants' attitudes or reactions to the EC regulations. The aim was to see how participants interpreted and or made sense of the impact of regulations either to their own organisations or to the UK securities industry and EU economy at large. The conceptions sought herein were therefore interpretive in nature and were consistent with the interpretivist philosophical orientation of this study. The resultant metaphors identified were taken from participants' own words (see for example Cornelissen, Oswick, Christensen, & Phillips, 2008). The analysis process involved the phases discussed below.

6.6.1 Phase 1: Reading through the interview transcripts

This phase involved the researcher initially reading through the interview transcripts to get a broad sense of participants' meanings and the context of their utterances. Reading across all the interview scripts allowed for the development of a general sense of the prevalence and consistency of metaphor usage across different participants and across different groups of participants.

6.6.2 Phase 2: Identifying and recording metaphors

This phase saw the researcher reading through the transcripts again, this time more carefully, picking out and recording individual occurrences of metaphors from the transcripts. A total of 77 metaphors were identified from the interview transcripts. The metaphors were recorded on cue cards to facilitate easy sorting and re-sorting into different themes or categories later on.

6.6.3 Phase 3: Sorting and grouping of metaphors into categories

The 77 cards representing each of the individual metaphors identified in the stage above were examined closely and subsequently sorted and grouped into related themes. The sorting exercise resulted in the emergence of eight metaphor themes:

(1) **Positioning / structuring** metaphors suggesting the possible manoeuvring for influence, power and hierarchical positions in the ratings market;

(2) **Voice metaphors** representing diverse and often conflicting opinions and perspectives of ratings, rating agencies, their roles and regulation thereof;

(3) **Power and influence** metaphors representing contested spaces between the regulators and the regulated entities as well as power and competitive dynamics among market participants;

(4) **Movement metaphors** depicting the dynamism, fluidity, uncertainty and self-structuring in the regulation of rating agencies;

(5) **Dependence metaphors** denoting linkages and inter-dependencies in the securities market resulting in difficulties to selectively deal with certain elements while leaving others;

(6) **Perimeter / Boundaries / Fences** metaphors depicting containment on one hand and or fencing off undesirable phenomena using relevant barriers on the other. This category also possibly suggested contested regulatory boundaries;

(7) **Celebration and crisis** metaphors depicting the blind and possibly careless exuberance that characterised the pre-crisis era, followed by the harsh crisis and its impact. The celebratory period equates to the exuberant years and their associated runaway practices, while the crisis equates to the economic meltdown that saw the collapse of a number of major corporations;

(8) Masks and appearance metaphors that suggested that a lot of the perceived activity and changes in the credit rating market possibly masked deeper and different realities that were far from the images portrayed externally.

6.6.4 Phase 4: Devising category descriptors

The above latent and descriptive categories were formulated by the researcher to encapsulate the different elements within each category. In some cases, there were diverging, almost conflicting elements within each category offering interesting perspectives on the same issue. The classification of metaphors in this format helped to create a typology of participants' contextual conceptions of issues in the regulation of credit rating agencies. The resultant typology is discussed in more detail in Chapter 7 and is akin to Hemingway (1952)'s iceberg theory showing that there is a deeper and richer depiction of reality beneath surface language (see for example Giger, 1977). In this case, when examined closely, participant's language conveyed deeper subconscious reactions to the research subject. The 77 metaphors drawn from interview transcripts are grouped into 8 themes shown on Table 24.

Table 24: Overview of metaphors identified in this study

Positioning	Voices	Agency relationships, influence & power	Movement	Masks, Appearances / Pretences	Perimeter Fence / Boundaries	Dependence / Interlinkages	Celebration, then crisis
CRAs not at the top of the food chain	sheer bloody bureaucracy	Level playing field	Fluid	Aim of increasing competition falls flat on its face	Narrow regulatory focus	Blind use of ratings	Pre-crisis period as a party
CRAs not at the top of the tree	Rating not the gospel truth	Davids and Goliaths	Flux	Regulatory compliance gobbling up budgets	One-size fits all	Herd-like behaviour	None dared take away the punch bowl
Crisis bigger than just the CRAs	Rating just one part of equation	Fire alarms	Regulation as a pendulum	Back to business as usual	Going overboard	Symbiotic relationship	Crisis as panic
Regulators out of touch	Production line behaviour	Eyes and ears	CRAs weren't up to speed	Changes are lip service	Chinese Walls	Free riding	Players got their fingers burnt
Missing the point	Mechanistic behaviour	Watch dogs	CRAs more uptight now	Box-ticking	Rating only a screen	Don't throw away the baby with the bath water	
Failure to join up the dots	Hard-wiring / coding	Guard dogs	Ratings tighter since the crisis	Regulation as window dressing	Bail-ins not bail-outs		
Lack of joined-up thinking	Ratings not forward-looking	Gate keepers	Regs have run off with the headlines	Packaging			
Patchy	Key part of comms channel	Slept on duty	Closing the gate after horses have bolted	Regulators as toothless bulldogs			
Passing the buck	Rating Process as a black box	Usual suspects	Reactive ratings				
Entirely for the birds	Rating process as a melting pot	Easy prey	Kneejerk reactions				
Only in the minds of politicians	Lack of transparency	Scapegoats	After shocks				
Catch-22 situation	CRA analysts bamboozled	Messengers					
Chicken-egg situation		Shooting the messenger					
New CRA entrants to earn their spurs							
Level-headedness							
Regs founded on shaky ground							
Rating a comparator							
Rating only a starting point							

In a study of taxi drivers' perceptions of customer service, Cassell (2012) used a similar approach to the one adopted in this study. Metaphors were identified from the transcribed interview data, analysed, and subsequently grouped into 5 themed categories. In yet another study investigating the use of metaphors in trade union change agency initiatives, Cassell and Lee (2012) adopted an inductive analysis of metaphors and looked at the language used by trade unions in New Zealand and the UK to describe their change agency roles. Seven metaphors were identified giving inferences to trade union change agency roles, raising interesting comparisons between managerial conceptualisations of change agency juxtaposed to views of trade unions.

6.7 Criticisms of metaphor analysis

One of the criticisms levelled against the use of metaphor analysis in management studies has been around the procedure of identifying metaphors in previous studies. Vervaeke & Kennedy (1996) particularly highlighted the lack of formalised repeatable, scientific procedures in metaphor analysis studies which they claimed hampered validity. This was echoed by Ritchie (2003) who argued that the selection of conceptual domains lacked robust, justifiable procedures.

The steps of analysing metaphors highlighted by Schmitt (2005), utilising the criteria set by Lakoff and Johnson (1980; 1999) provided a robust framework which when implemented carefully, played down the criticisms aired by Vervaeke & Kennedy (1996) and Ritchie (2003) above. In this study, the identified metaphors were robustly derived from participants' language. The clearly articulated analysis steps highlighted in this study are repeatable and robust enough, giving confidence on the findings.

While the steps outlined herein provide an audit trail for easy verification to ensure validity, this does not take away the essence of the subjective, interpretive perceptions of the different participants which provide rich and varied visualisations of reality. Further, the researcher's interpretation of participants' metaphors also throws in an element of subjectivity consistent with interpretive tenets of this study.

To mitigate adverse effects of subjectivity in interpreting metaphors, the contextual utterances surrounding metaphors were clearly identified to ensure that contextual

meanings were objectively identified. To ensure that non-metaphor data was also used to enrich findings from the metaphor data, a second analysis approach was devised to focus specifically on non-metaphor data. Findings from this second analysis approach helped to validate the outcome of the metaphor analysis findings. The non-metaphor data was analysed and coded, breaking it down into related data sets to identify emerging themes. The detailed process is discussed in Section 6.8 below.

6.8 Overview of non-metaphoric data analysis

The analysis of non-metaphor data followed Miles & Huberman (1994)'s three concurrent steps of data reduction, data display and conclusion-drawing (see Figure 9). Data reduction was carried out using an adaptation of Creswell (2002)'s 5-step process presented in Table 25 below.

Table 25: Creswell (2002)'s Five Step Data Reduction Process

	Stage description	Comments /Adaptations
1	Initially reading through the data to make sense of the broader context of the utterances,	*Scanning through the data to get a contextual sense of broader meanings*
2	Identifying segments of related data sets	*As 8 segments had been identified from the metaphor analysis phase, non-metaphor data sets were grouped and aligned to the 8 categories*
3	Labelling the identified segments to create categories	
4	the reduction of overlaps and code redundancy	*Rearranging data sets to minimise repetition*
5	The creation of a model incorporating the emerging categories.	*See chapter 7: sense-making of the data categories and drawing out inferences for this study.*

Adapted from Creswell (2002)

This procedure allowed for a systematic approach to analysing non-metaphor data and ensured the capturing of participants' responses relating to their perceptions of the impact of the EC CRA regulations on the operations of the UK securities market were identified, categorised and inferences drawn. Reading through the data resulted in related data sets being grouped together and codes assigned to them.

Subsequent steps involved the amalgamation of related data sets into broader, more cohesive categories to build broader themes. The analysis of the non-metaphor data yielded 25 categories which upon further analysis, were aligned to the categories identified in the metaphor data analysis. The 25 categories were subsequently dovetailed into the 8 categories identified in the metaphor data section. Table 26 below summarises the 25 categories and the related 8 broader categories.

Table 26: Summary of non-metaphor data categories

Non-metaphor data sets in category	Broader Data Categories
New CRAs vs. uneven competitive landscape	**Positioning / structuring**
Perceived EC regulatory motives (political/market driven?)	
Local vs. global - Coordination and scope of EC regulations	
Competitiveness vs. credibility - Catch-22 situation dilemma faced by new CRAs	
Subjective or objective - nature of credit ratings	**Voices**
The paradox of credit ratings – crucial yet disclaimed	
Perceived accuracy of regulators' diagnosis of market problems	
Views on proposed EU-sponsored CRA	
Possible alternative CRA funding models	
Perceived responses to the 2007-8 crisis	**Movement**
Timing of the EC regulatory initiatives	
Perceived market changes post the crisis	
Proposals for possible future improvements	
Perceived EC regulatory benefits	**Masks, appearances and pretences**
Real or made up - perceived EC regulatory impact	
Perceived EC regulatory costs / burdens	
Perceived unintended consequences of EC regulatory initiatives	
Perceived effectiveness of EC regulatory initiatives	
Proportionality of EC regulatory initiatives	**Perimeter / fence, boundaries**
Perceived EC regulatory scope creep	
Perceived regulators' competence	**Relationships, power and influence**
Relationships and network influences	
Rationale for CRA choice	**Dependences / interlinkages**
Perceived causes of the crisis	**Celebration / crisis**

Source: Compiled by author

With all the data analysed, the stage was set for a detailed discussion of what insights could be gleaned from the data as well as what inferences could be made from the data to inform this study. The next section summarises the data analysis chapter, paving way for a detailed discussion of the study findings in Chapter 7.

6.9 Chapter summary

This chapter presented an overview of the data analysis approach adopted in this study. The chapter began by broadly discussing qualitative data analysis issues before focusing on metaphor analysis and subsequently, the approach adopted to analyse interview transcripts in this study. It was acknowledged that the analysis of qualitative data was one of the most challenging steps in dealing with qualitative studies. Notwithstanding these challenges, various scholars' work was used to offer guidance on some of the tried and tested methods involving the initial reading of data for sense making; identification of themes in the data; grouping of themes into related data sets; labelling or coding the themes as well as the amalgamation of related themes to form broader categories. Such steps prepared the data for more insightful analysis where closer scrutiny could be conducted both within the identified categories as well as across the categories.

Data analysis followed two approaches. The first approach involved the use of the metaphor analysis method which involved inductively identifying metaphors used in participants' interview transcripts. This resulted in the identification of 77 individual metaphors used by participants during the interviews. The 77 metaphors were subsequently grouped into 8 broad categories. The second analysis approach involved analysing the non-metaphor data, resulting in the data being grouped into 25 themed categories. The data categories were coded for easy identification and manipulation. The 25 categories were subsequently streamlined into the 8 previous metaphor categories as there were correlations between them. The amalgamated results were summarised in Table 26 and will be discussed in more detail in Chapter 7 of this thesis. The next chapter begins by offering a broad overview of the 8 categories of data embodying participants' conceptualisations of the impact of the EC regulatory initiatives on the UK securities market. Thereafter, a detailed discussion of each category is given, making linkages to extant literature in the area of credit ratings as well as drawing out inferences and implications for the study area.

Chapter Seven:

Findings and Discussion

7.0 Introduction

This chapter presents the study findings, giving a précis of each of the emerging data categories incorporating both metaphor and non-metaphor data sets. To ensure deeper underlying insights embodied in participants' language are brought to the fore, the analysis largely focused on embedded metaphors and subsequently mapped the related non-metaphor data categories to corroborate findings from the two data sets. The chapter offers an evaluation, interpretation and discussion of the findings. Inferences are drawn from the findings and related to extant literature in the areas of credit rating agencies and regulation. The endogenous regulation theory is invoked to help explain the emerging themes. Section 7.1 below gives an overview of the 8 broad categories incorporating both the 77 metaphors and the 25 non-metaphor data sets all derived from participants' interview transcripts. Thereafter, inferences and interpretations are made from the findings discussion. The chapter then explores the implications of the findings to the regulation of credit rating agencies as perceived by UK-based market participants.

7.1 Overview of the findings

As highlighted above, the study findings comprising both metaphor and non-metaphor data sets grouped into the 8 categories summarised in Table 27.

Table 27: Summary of data categories

Category	Metaphors in category		Non-metaphor categories
Positioning metaphors	Rating only a starting point	Passing the buck	Coordination, nature and scope of EC regulations
	Rating a comparator	Patchy	
	Regulations founded on shaky ground	Lack of joined-up thinking	
	Level headedness	Failure to join up the dots	Competition, and reputation
	New CRA entrants to earn their spurs	Missing the point	
	Chicken and egg situation	Regulators out of touch	Catch-22 situation - dilemma faced by new CRAs, uneven market
	Catch-22 situation	CRAs not at the top of the tree	
	Only in the minds of politicians	CRAs not at the top of the food chain	Perceived EC regulatory drivers; suspicious motives
	Entirely for the birds	Crisis bigger than just the CRAs	
Voice metaphors	CRA analysts bamboozled	Hard-wiring / hard-coding	Nature of credit ratings
	Lack of transparency	Mechanistic behaviour	Role of credit ratings
	Rating process as a melting pot	Production line behaviour	Possible alternative CRA funding models
	Rating process as a black box	Rating just one part of equation	Views on proposed EU-sponsored CRA
	Rating a key part of communications channel	Rating not the gospel truth	Perceived accuracy of regulators' diagnosis of market problems
	Ratings not forward-looking	Regulation as sheer bloody bureaucracy	

Category	Metaphors in category		Non-metaphor categories
Relationships, influence & power	Shooting the messenger	CRAs as Gatekeepers	Relationships and network influences
	CRAs as messengers	CRAs as guard dogs	
	CRAs as scapegoats	CRAs as watch dogs	
	CRAs as easy prey	CRAs as eyes and ears	Perceived regulators' competence
	CRAs as usual suspects	CRAs as fire alarms	
	Sleeping on duty	Davids and Goliaths	
		Level playing field	
Movement metaphors	After shocks	Ratings tighter since the crisis	Perceived responses to the 2007-8 crisis
	Knee-jerk reactions	CRAs more uptight now	
	Reactive ratings	CRAs weren't up to speed	Perceived market changes post the crisis
	Closing the gate after horses have bolted	Regulation as a pendulum	Proposals for possible future improvements
		Regulatory environment a state of flux	
	Regulators run off with headlines	Regulations fluid	Timing of the EC regulatory initiatives
Masks, appearances and pretences	Regulators as toothless bulldogs	Changes are lip-service	Perceived effectiveness of EC regulatory initiatives
	Packaging of securities	Back to business-as-usual	Perceived EC regulatory impact
	Regulation as window-dressing	Regulatory compliance gobbling up budgets	Perceived EC regulatory costs / burdens
	Regulation as box-ticking	Aim of increasing competition falls flat on its face	Perceived unintended consequences of EC regulatory initiatives
			Perceived EC regulatory benefits
Perimeter fence / boundary metaphors	Bail-ins, not bail-outs	Going overboard	Perceived EC regulatory scope creep
	Rating only a screen	One-size fits all	
	Chinese walls	Narrow regulatory focus	Proportionality of EC regulatory initiatives
Dependence / interlinkages metaphors	Don't throw away the baby with the bath water	Symbiotic relationship	Rationale for CRA choice
		Herd-like behaviour	
	Free riding	Blind use of ratings	
Celebration / crisis metaphors	Got their fingers burnt	None dared take away the punch bowl	Perceived causes of the crisis
	Crisis as a panic	Pre-crisis period as a party	

Source: Compiled by author

The categorisation of metaphor and non-metaphor data into the above eight groups was based on the researcher's interpretation of their contextual meanings.

The categories are therefore subjective and consistent with the interpretivist tenets of this study. However, in coming up with the eight categories, the researcher took into consideration participants' contextual utterances as a way of mapping and positioning such utterances to derive requisite meanings embodied in the metaphors. The sections below give an overview of how each of the category descriptors was developed together with details of the data sets contained within.

The first category comprised 18 individual metaphors drawn from interview transcripts signifying some form of positioning across time, contextually, relationally and mentally. Consequently, positioning was used as the overarching category for this group of metaphors. Non-metaphor data was drawn from interview transcripts to corroborate metaphor findings, looking at positioning issues across the industry. Table 28 below summarises the percentage frequency of participants' responses on positioning metaphors and related non-metaphor data.

Table 28: Percentage responses on positioning metaphors

Category	Metaphor	CRAs	OIPs	Investors	Issuers
Positioning	Catch-22 situation / chicken-egg situation	83%	40%	-	50%
	CRAs not at the top of the food chain / CRAs not at the top of the tree	17%	60%	-	10%
	Crisis bigger than just CRAs	50%	60%	11%	-
	Entirely for the birds / unjustified regulations / Only in the minds of politicians	-	20%	22%	50%
	Failure to join up the dots / Lack of joined up thinking / failure to see the big picture	50%	60%	55%	70%
	Level-headedness / balanced, reasoned approach	-	20%	22%	-
	Missing the point	67%	60%	44%	30%
	New CRA entrants to 'earn their spurs' / build reputation / fight for recognition	17%	40%	66%	50%
	Passing the buck	17%-	20%	11%	-
	Patchy	17%	60%	55%	-
	Rating a comparator/ Rating only a starting point	67%	60%	33%	20%
	Regulations founded on shaky ground	67%	60%	11%	50%
	Regulators out of touch / mismatch with market expectations	50%	40%	33%	30%

Source: Compiled by author

From the above table, a significant number of participants felt that the justification for regulation was questionable; that regulators were missing the point; that there was a general failure to make strategic linkages in the market and that introduction of more CRAs would not necessarily enhance competition. These issues are further discussed in section 7.2.1.

The second category of metaphors comprised 12 individual metaphors signifying points of view, opinions, scepticism and deeply-ingrained perspectives and behaviours. This was aptly-labelled the 'voices' category in recognition of the varied and often-conflicting views embodied in the metaphors and participants' opinions. Non-metaphor data depicting varied perspectives and reactions towards regulatory issues and their impact were further appended to this category. Table 29 below captures the breakdown of participants' responses against the different metaphors and associated non-metaphor responses in this category.

Table 29: Percentage responses on voice metaphors

Category	Metaphor	CRAs	OIPs	Investors	Issuers
Voice metaphors	Black Box/mystique / mysterious / opaque	-	40%	33%	40%
	CRA analysts bamboozled / comparatively inexperienced	-	60%	11%	-
	Hard-wiring / Hard coding	17%	40%	56%	20%
	Lack of transparency	-	60%	44%	10%
	Melting pot	-	40%	-	-
	Production line behaviour / Mechanistic behaviour	17%	60%	11%	10%
	Rating just one part of the equation	83%	60%	44%	40%
	Rating not the gospel truth	83%	60%	44%	40%
	Ratings key part of comms channel	83%	-	11%	60%
	Ratings not forward-looking	-	20%	-	-
	Sheer bloody bureaucracy	-	20%	-	-

Source: Compiled by author

Participants highlighted the lack of clarity on what ratings meant; the subjective nature of ratings on one hand, contrasted with the reliance on and entrenchment of ratings into investment decision-making processes. This is discussed in more detail in section 7.2.3.

The third group contained a total of 13 individual metaphors signifying agency relationships, custodianship, finger-pointing, blame, culpability and power. An overarching label of 'power and influence' was assigned to this category denoting the power relationships behind the different players in the CRA regulation debate. Table 30 offers a summary of the percentage responses of participants' reactions towards metaphors in this category.

Table 30: Percentage responses on relationship/power metaphors

Category	Metaphor	CRAs	OIPs	Investors	Issuers
Relationship, power and influence metaphors	Davids and Goliaths	-	20%	11%	10%
	Easy prey	33%	40%	-	40%
	Eyes and ears	-	20%	33%	-
	Fire alarms	-	60%	22%	10%
	Gate keepers	-	20%	33%	20%
	Guard dogs	-	20%	11%	-
	Level playing field	17%	20%	-	40%
	Messengers / shooting the messenger	83%	20%	11%	10%
	Scapegoats	33%	40%	-	20%
	Slept on duty	-	20%	56%	40%
	Usual suspects	17%	20%	-	-
	Watch dogs	-	20%	33%	20%

Source: Compiled by author

Power and influence issues were identified as key in the repositioning effect of the new regulations and non-metaphor issues around this theme provided a useful background to depict the perceived competence and power of regulators, influence on relationships and network effects. There was a poignant contrast between participants' conceptions of CRAs and the agency relationships in the ratings industry as opposed to how CRAs saw themselves, their role and influence in the relationships. A further analysis of data sets in this category is offered in 7.2.4.

The fourth category contained 11 metaphors depicting physical movement, temporal, figurative and virtual movement and was assigned the label of 'movement' metaphors. Table 31 offers an overview of participants' responses in this area.

Table 31: Percentage responses on movement metaphors

Category	Metaphor	CRAs	OIPs	Investors	Issuers
Movement	After shocks	-	20%	11%	10%
	Closing the gate after horses have bolted	33%	80%	44%	60%
	CRAs more uptight now / Conservative	-	80%	44%	30%
	CRAs weren't up to speed	17%	100%	56%	60%
	Fluid / flux	50%	40%	44%	60%
	Kneejerk reactions (regulation)	67%	40%	56%	30%
	Ratings tighter since the crisis / stringent	17%	80%	44%	80%
	Reactive ratings /	-	20%	-	-
	Regulation as a pendulum / swings	17%	40%	56%	40%
	Regulators have run off with the headlines	17%	40%	-	50%

Source: Compiled by author

Using non-metaphor data, the concept of time was key in evaluating changes in the credit rating market as well as the regulatory space. This related very well to the metaphor of movement depicting both changes as well as the shifting regulatory landscape. Participants noted a reactive approach both by rating agencies as well as by regulators in dealing with issues in this market. A more detailed discussion is offered in 7.2.5.

The fifth category comprised 8 metaphors signifying perceived false realities, pretences and masks. Consequently, this was given the label of "masks, appearances and pretences" to capture the overarching theme of pretence deduced from participants' utterances. The metaphors are summarised in Table 32.

Table 32: Percentage responses on masks / appearance metaphors

Category	Metaphor	CRAs	OIPs	Investors	Issuers
Masks, appearances / Pretences	Aim of increasing competition falls flat on its face	83%	80%	44%	60%
	Back to business-as-usual	17%	20%	-	10%
	Box ticking (regulation)	33%	40%	33%	20%
	Changes are lip service	-	40%	44%	-
	Packaging	-	-	44%	-
	Regulation as window-dressing	33%	40%	44%	30%
	Regulators as toothless bull dogs / ineffective	17%	40%	44%	20%
	Regulatory compliance gobbling up budgets	100%	-	-	-

Source: Compiled by author

Non-metaphorically, this category focused on the aftermath of the regulation, highlighting both anticipated positive changes and what was made to look like real changes on the ground. This category also highlighted the concerns for possible unintended consequences of the regulations. Themes in this category are further followed up in 7.2.6

The sixth category consisted of 6 metaphors indicating containment, limits and boundaries. "Perimeter fence and boundary" metaphors therefore seemed to be a fitting description for this category. Table 33 offers the frequency of responses against each of the metaphors in this category.

Table 33: Percentage responses on perimeter / fence metaphors

Category	Metaphor	CRAs	OIPs	Investors	Issuers
Perimeter Fence / Boundary metaphors	Bail-ins, not bail-outs	-	40%	-	-
	Chinese Walls (separation of analysis from business development within CRAs)	50%	60%	67%	60%
	Going overboard / exceeding mandate	17%	40%	11%	10%
	Narrow regulatory focus	17%	60%	11%	30%
	One size fits-all / blanket or broad-brush approach	83%	60%	67%	50%
	Ratings only a screen	67%	60%	33%	20%

Source: Compiled by author

Participants expressed strong views on the scope of the regulation, its reach as well as perceived proportionality of regulatory responses. Most reactions seemed to come from Other Interested Parties, denoting a concern on possible negative effects of the regulations to the broader securities market. This is further discussed in 7.2.7.

The seventh category of 5 metaphors denoted connections, reliance and trust. The label of "dependencies and interlinkages" was therefore assigned to this category. Participants' responses in this category are summarised in Table 34 below.

Table 34: Percentage responses on dependence metaphors

Category	Metaphor	CRAs	OIPs	Investors	Issuers
Dependence and linkage metaphors	Blind use of ratings	67%	100%	33%	50%
	Don't throw away the baby with the bath water	-	40%	-	10%
	Free riding	17%	60%	67%	20%
	Herd-like behaviour	-	60%	17%	30%
	Symbiotic relationship	-	40%	-	-

Source: Compiled by author

Participants highlighted the intricate issues behind the choice of CRAs in the market, painting a picture of closely intertwined relationships where it was not immediately clear how to isolate and separate players as was insinuated by the regulatory approach. The suggestion was for a more holistic approach as discussed in 7.2.8.

The last group comprising four metaphors signifying initial extravagance and subsequent implosion of the global securities system was labelled "celebration and crisis" to denote the pre-crisis exuberant mood and the subsequent crisis that followed. Table 35 captures the frequency of participants' responses in this category.

Table 35: Percentage responses on celebration / crisis metaphors

Category	Metaphor	CRAs	OIPs	Investors	Issuers
Celebration and crisis metaphors	Crisis as a panic	17%	60%	11%	30%
	None dared take away the punch bowl	-	40%	-	50%
	Players got their fingers burnt / suffered the consequences	17%	20%	33%	30%
	Pre-crisis period as a party	-	20%	-	20%

Source: Compiled by author

From both the metaphor and non-metaphor data, participants highlighted the perceived causes of the crisis and linked this to the debilitating effects of the crisis to the global market. This thought is further developed in 7.2.9. The ensuing sections offer an in-depth discussion of the metaphors to draw out participants' implied meanings and what these may mean with regards to participants' perceptions of the impact of the EC Credit Rating Agency regulations. As participants were UK-based, implications drawn from this study apply to the UK ratings and securities market and where specified, the EU credit ratings market.

7.2 Discussion and interpretation of the findings

Following the descriptive outline of the emerging data categories extracted from the study participants' transcripts, the sections below go on to analyse each data category to draw out inferences and implications for the regulation of credit rating agencies in the UK securities market, relating this to the broader EU context. Relevant extant literature is later drawn in to contextualise the findings within the focus of the study. The primary analysis focuses on the metaphors used by participants with non-metaphor data (also drawn from the interview transcripts) used to corroborate and explain the findings in more detail.

Section 7.2.1 below opens the discussion by looking at the first category of positioning / structuring metaphors and associated non-metaphor data. All metaphors are shown in italics and in quotation marks.

7.2.1 Positioning and structuring metaphors

Participants felt that the disputed nature and role of credit ratings lay at the centre of issues affecting the credit rating industry. Credit ratings were depicted as "*comparators*" suggesting that their use should have been in relation to other forms of due diligence as opposed to credit ratings being used as an end in themselves. Ratings were therefore said to be "*a starting point*" on which users had to add further evaluations or views, prior to making investment decisions. It was felt that on the contrary, evidence suggested that market participants and regulators had relied too much on credit ratings in the period leading up to the 2007-8 crisis, failing to validate the credit ratings with their own additional due diligence measures.

The overarching metaphor of positioning was suggestive of deeper underlying competition for power, influence and control. The very nature of the regulations was perceived as an attempt by the European Commission to curb the powers of credit rating agencies and assert the authority of the EC (and behind it, the EU) across all member states. There was therefore a clear tension between the expanded EC regulatory role and the impending limits on CRAs' and other market participants' freedoms. This will be further highlighted under the discussion of the '*boundaries and fences*' metaphors in section 7.2.7. The proposed regulations did not spell out what the future role of CRAs and other market participants would be in the new dispensation, an issue which perhaps evoked stronger reactions as CRAs and others sought to make their representations in an attempt to guarantee their continued survival.

At a local level, participants ranked different players based on their perceived contribution to the crisis as a way of inferring levels of culpability. This was manifested through metaphoric references to rank, pecking order, hierarchy and sequential order positions. Specifically, participants argued that CRAs were "*not at the top of the food chain / not at the top of the tree*" inferring that if blame were to be apportioned, CRAs were not perceived to be the highest-ranked culprits among those alleged to have caused the crisis.

Positioning "*at the top of the tree*" or on a "*food chain"* has connotations of the perceived importance of CRAs in fuelling the crisis or feeding the rest of the system. The fact that CRAs were said to be lower down in the chain suggests that they should not be singled out as primary regulatory targets. This implies that participants perceived that there were (and still are) others of more significance that ought to have been considered alongside or ahead of CRAs. Alternatively, all elements of the chain could be considered relationally so that their positions in the system could be analysed and decisions made not just on one; but rather, on the whole system and its members. The implication therefore is that isolated application of regulatory remedies to one entity in an integrated system may suggest a narrow focus which is likely to miss out on some key issues, possibly causing further system imbalances.

The above point was further strengthened by the notion of regulations "*missing the point,*" implying that certain market fundamentals may not have been clearly understood or addressed by the regulators. Just like in a food chain, there were dependencies with each layer dependent on those further down the chain for sustenance. Actions taken on one level could have drastic effects on the entire system because of the dependencies. A narrow or "*patchy*" regulatory focus could therefore either leave out key issues or lack coherence and coordination ('*lack of joined up thinking'*), posing unintended risks in other parts of the system. The suggestion was that regulators needed to take a holistic, balanced and "*level-headed*" approach to implementing credit rating agency regulations.

Participants were concerned that the stated market failure basis of the EC regulations was weak with "*regulations founded on shaky ground*" particularly as some alleged regulation drivers were said to have been unrealistically conceptualised, existing "*only in the minds of politicians.*" This suggested that the understanding of the problems by regulators was perceived to be divorced from reality and largely shaped by what participants perceived to be regulators' limited understanding of how they thought the rating market worked. This was partly because regulators were viewed as being "*out of touch*" and divorced from the complex, practical credit rating issues on the ground, resulting in them devising regulations that were perceived to be so unrealistic such that they were "*entirely for the birds*." This point was underscored by CR1 who said:

> *"I think there was…here I'll pick on structured finance; I don't think there was enough understanding at the regulatory level of what was going on. Here I speak more to the inputs to the rating analysis rather than the tools we used themselves. You look at the tools used, the Monte Carlo simulation models and such... In their own right, there is not a huge amount that is wrong with them but if you look at US RMBS, a key input to RMBS is, house prices were rising. The scenario that house prices might go down was inadequately addressed, so did the regulators do enough to look at scenario analysis to mitigate risks? I think the answer is No, they could have been stricter about scenarios you must analyse"*

It would be interesting to investigate whether regulators' perceived grasp of the activities in the market after the crisis changes with time and to what effect. Other key issues cited by participants related to the fact that regulators, like market participants and other players were "*passing the buck*" or shirking responsibility. This was said to be manifested for example in the denial of any responsibility towards ever contributing to the 2007-8 crisis. Consequently, regulatory proposals were aimed at addressing issues out in the market, with very little focus on addressing internal regulatory failures. IS9 argued that failures leading to the 2007-8 crisis extended right up to Government level and summed up the argument as follows:

> *"I think it probably is that governments have gone along very happily with the build-up of debt across both corporates and financial institutions and should have, I suppose ... set up a mechanism for regulation and none of them did. So it's not regulators themselves that are to be blamed because the regulators were not given the mandate to go out and spot the build-up of debt that was actually needed. Their governments could have given that mandate to regulators and they didn't. Because they were enjoying the growth that was coming from the build-up of debt without realising that at some point in the future, that debt has to be paid back"*

Governments and their regulators were therefore said to be partly to blame for the crisis and consequently, any meaningful proposals to address the problem should have been holistic rather than pick isolated players. There was an argument therefore that issues were allegedly viewed in isolation both before and after the crisis, with an endemic "*failure to join up the dots*" This allegedly clouded the systemic view of the securities market.

As an example, OP2 described the myopic view that some market participants took in the ratings market leading up to the crisis:

"... So a lot of people who saw Iceland had a single A rating didn't go on to notice that it had a negative outlook, and they didn't go to read the BICRA[12]., ...they didn't look at the way in which the local currency credit rating of the Icelandic government differed from the foreign currency rating of the Icelandic government because it had a lower rate for foreign currency obligations. That tells you something, it tells you a lot. They didn't go and look at the BICRA which said they (the Gvt) couldn't help anyway, they can't meet foreign currency obligations and they are not going to help anyway. If you looked at the full set of ratings relevant to those Icelandic banks, you wouldn't have put any significant amount of money with them. But people didn't join up the dots, they just saw that it said single - A rating; that's fine"

There was thus a perceived "*patchy*" approach to viewing ratings market issues both by regulators and by market participants alike. This limited view of issues did not, and may not help solve market problems. A holistic view was said to be necessary to evaluate problems in their contexts and consider solutions that fit within the broad market context. Notwithstanding the above evidence of poor practice, there were other practitioners who claimed to have proactively spotted the signs of trouble and did the right thing as evidenced by IN2's statement below:

"It's Iceland, it's got the population of Swindon, what credibility can it have as a country to support something, it's a small country with this big structure on top of it, so we never lent to Icelandic banks. We always took a sceptical view of things"

With regards to the issue of lack of competition among CRAs, regulators proposed encouraging more CRAs to enter the market. In response to this point, study participants argued that new CRAs faced a *"chicken-and-egg situation / catch-22 situation"* particularly as they needed to demonstrate a credible track record prior to being accepted by rating users. On the other hand, rating users would not readily accept and use new CRAs without the afore-mentioned credibility. The conclusion was therefore that "*new CRA entrants had to earn their spurs*" first if they were to get customers. Study participants argued that regulators' intentions of merely increasing the number of CRAs in the market would not address the problem of lack of competition but could instead cause problems related to ratings quality.

If rating users did not use the new CRAs owing to lack of credibility and track record, such new CRA entrants could be driven out of business. Further, participants observed that the very nature of the new EC regulations imposed prohibitive compliance costs which could work against new CRA entrants.

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Such compliance costs were said to be acting as barriers to entry. New CRA entrants would not have the resources to set up the structures required to meet the EC regulatory demands. This point was perhaps best articulated by CR5 who emphasized that:

> *"...there's no question about the compliance costs, they have increased substantially and the burden falls heavier on the smaller firms and on a proportionate basis, there's no question about that"*

The fact that regulators did not seem to have envisaged the impact their actions could have on new CRA entrants further corroborated the claim that there was "*failure to join up the dots*" and understand regulatory implications holistically. This raised questions on the competence of regulators and their understanding of the complex operational issues on the ground in the ratings market. The role of regulators exogenously dictating regulations to regulated entities is challenged by the endogenous regulation theory perspective which this study seeks to make a contribution to. This issue is discussed in more detail in section 7.4. The central theme here emanates from shifting power balances where regulators propose a new dispensation, yet they do not clearly calibrate the exact role of key stakeholders such as CRAs in this new regulatory dispensation.

Consequently, such stakeholders are actively challenging the regulatory approach as they fight for their future in an uncertain environment.

7.2.2 Implications of positioning and structuring metaphors

Three implications could be drawn from the positioning and structuring metaphors discussed above. The implications can be broken down into: (i) the understanding of ratings and their use; (ii) regulatory drivers, approach and associated implications as well as (iii) competition in the ratings market. These are discussed in more detail below.

7.2.2.1 Understanding of ratings

Participants in this study underscored the fact that market participants and regulators alike were perceived to lack an understanding of what credit ratings stood for. This was highlighted by IN2 who observed that:

> *"I don't think there was a lot of understanding of the ratings, I'm not sure it's that much wider now. It's a hard thing to appreciate this difference between different structures and ratings. A bank is a bank for a bank to go bust is a hell of a big thing but for a structured product to lose its rate and default, it didn't even make the bottom page of the financial press, yet someone has lost their money.."*

When issuing ratings, CRAs accompanied them with extensive disclaimers, suggesting that users should be cautious in basing any investment decisions on them (White, 2001). Notwithstanding such disclaimers, there seemed to have been blind use of, and over-reliance on ratings not just by users, but by regulators as well (Papaikonomou, 2010; White, 2010a). An investor, IN2 commented on the prevalent blind use of ratings prior to the global financial crisis:

> *"I was involved at one point in getting a AAA money market fund rated and I was quite surprised how much they relied on information that we were giving them without doing any audit on it at all. I was really quite shocked, you would hand them information and it would have detailed questions on it and stuff, but they were relying all the time on you telling them and even during or once the stages got going, or reporting on the credit quality and things coming from us with no audit at all.."*

Coming from an investor, the above points to an inherent blind acceptance of ratings, coming at a time when such ratings were themselves disclaimed by CRAs who issued them. There is thus a paradox of disclaimed ratings that are generated in a loosely-regulated context being blindly used as concrete investment guidelines (Partnoy, 2001). There is a deeper theoretical debate about what ratings stand for; whether they are objective or subjective and to what extent they should be relied upon (Elkhoury, 2008; White, 2010a). The argument that ratings are opinions and should be taken merely as guidelines was underscored by OP6 who observed:

> *"Obviously it's only a rating agency's opinion. It doesn't have any special crystal ball into the future, and it's a measure of the likelihood of default, which is partly a problem but it doesn't give any measure of the loss given the default, and really as an investor you want to know what's the chance of it going under"*

The above observations, together with the extensive disclaimers issued by CRAs to accompany ratings, raise interesting questions about the credit rating agency model, considering that users pay so much money for what turns out to be disclaimed opinions. If ratings are such subjective opinions, why do regulators and market participants place so much emphasis on them; is this in any way linked to the coercive nature of ratings as quasi-regulatory tools?

There are fundamental questions about the pervasive nature of ratings; juxtaposed to the questionable construct of ratings. This raises questions on whether users are now coercively bound to the ratings in a fashion best captured by DiMaggio & Powell (1983)'s iron cage metaphor depicting institutions as iron cages that despite being man's creation, eventually take over and seem to contain and constrain man's behaviour.

The inadvertent endorsement of ratings by regulators did not seem to have helped the hyped-up position of ratings. This was done through the embedding of ratings in determining minimum capital adequacy requirements for depository institutions Hunt (2008), as well as under the BASEL II accord, (Claessens, 2003). Table 2 from Deb et al, (2011) offered a summary of some of the investment guidelines designed around credit ratings to show how pervasive ratings were in the investment community. Regulators discouraged market participants' reliance on ratings on one hand but continued to leave ratings at the core of key capital market requirements and investment decisions on the other. Consequently, the position of regulators on ratings became conflicted and somewhat confused. This anomaly potentially undermined the credibility of regulatory claims on ratings as far as market participants perceived.

This study's participants argued that unless the reliance on ratings by regulators was removed, any attempts to dissuade users from relying on such ratings would be perceived as double standards and would likely bear little fruit. Regulators therefore need to find a way of reducing regulatory-reliance on ratings (FSB, 2010).

7.2.2.2 Regulatory drivers, approaches and associated implications

The perception that regulators lacked understanding of complex practicalities in the securities market did not inspire confidence among market participants. Further, the fact that the new regulator, (ESMA) was envisaged to have an arms-length relationship with regulated entities, was said to suggest further possible disconnections with the already disparate market. This questioned regulators' understanding of securities and rating market issues on the ground, their efficacy and responsiveness to possible issues. These were not new issues. Commenting on the IOSCO code, Cinquegrana (2009) argued that the nature of the code made it unenforceable and rendered it ineffective.

An analysis of the EC regulations shows them to be too high-level, lacking the finer details that address the operational implementation issues of interest to market participants on a daily basis. Unless such details are filled in, the regulations remain fuzzy. Despite the setting up of ESMA as the new EU regulator, new concerns arose over the capability of ESMA to effectively regulate across the 27 EU member states. The argument was that ESMA was under-resourced, with a staff compliment of 75 people out of which about 15 were dedicated to securities regulation (Rennison, 2012). This further cast doubt over regulatory capabilities and competence to effectively address issues identified as having caused the 2007-8 crisis. At the time of writing this thesis, there had been three major revisions of the EC CRA regulations. These revisions resulted in CRA1, CRA2 and CRA3, each with slightly amended regulatory objectives and associated implications for implementing the regulations.

While these adjustments indicated regulators' responsiveness to dynamic developments in the market, participants in this study were sceptical that rapid amendments to the regulations indicated that regulations had not been well thought-through in the first place and were therefore not future-proof.

Further, there were political insinuations cited as possible drivers behind the regulations (Posner, 2010), suggesting that the whole regulatory exercise may have been a box-ticking and window-dressing political act. OP2 was very direct on this and commented:

> *" It's mainly because the reason behind credit rating regulations is that the continental Europeans particularly the French and the Germans have always wanted to regulate the rating agencies, not for any reason, just that they ought to be regulated; they like regulation. When we said to some of the CESR people who were pushing for this, 'what is the market failure which you are seeking to rectify, what is the justification for your regulation, they said 'regulation does not need a justification!'It's that sort of attitude I'm afraid…"*

The view above asserted that the EC regulations were an entrenchment of the European Union structures across EU market states and although this was presented as a response to the 2007-8 financial crisis, it would have happened regardless. There seems to be a view that the UK is generally opposed to encroachment of EU institutions into individual member states (Rennison, 2012). With that in mind, this study's findings are therefore not surprising.

These conceptions of regulation corroborate claims in extant literature (see for example Benston 1998; Lee 1980) regarding the possible multi-faceted drivers for regulation. The implication here is that regulators need to clearly articulate the regulatory agenda much more effectively to get buy-in from all key stakeholders, otherwise conspiracy theories engulf and threaten to derail the regulatory implementation process.

The use of positioning metaphors depicted the regulatory process as contested space, where regulations were not just handed down to the regulated (Selznick, 1985). The conceptualisation of regulators as "*out of touch*" positioned them away from market realities and suggested that the formulation of regulation happened rather remotely from the market. Participants reacted to this view and expressed an interest to engage with the regulatory process, advocating a regulatory approach that would be co-determined, negotiated with active advocacy and influence from those regulated (Freeman & Langbein, 1998). The above keenness of participants to engage with the regulatory process could partly emanate from the lack of clearly calibrated roles and responsibilities of different players in the new regulatory landscape.

By ushering in new regulations, regulators did not spell out what the future role of CRAs and other participants would be. Instead, there was evidence of powers being taken away from incumbent CRAs without any clarity on whether the CRA role would continue or disappear in future.

Consequently, it is not surprising that CRAs and other market participants seemed anti-regulation as they fought to secure their own future, viewing regulation as an onslaught. In fact, CRAs and other participants could have been seeking to engage the regulators in a bid to influence regulations from within. This social constitution of regulation posited that there were shared responsibilities between the regulator and the regulated entities such that the resultant regulations were embedded in the regulated community, engendering better ownership and cooperation (Malloy, 2010).

The point above touches on the question of whether regulation is exogenous or endogenous as well as the role and interaction of regulators and those regulated.

It is one of the central contributions of this study, questioning seminal regulation literature (see for example Baldwin, 2008; Baldwin & Cave, 1999; Baldwin et al., 2012) which treated regulated entities as somewhat silent in the regulatory formulation process. Participants in this study expressed a desire to engage and influence the regulatory process rather than be victims of regulation. Further, the seeming lack of closer understanding of intricate market issues by regulators suggested that a better regulatory outcome could have been attained if regulators had engaged with those regulated. This concept is discussed in more detail in section 7.4.

7.2.2.3 Implications of attempting to increase competition among CRAs

While there is a consensus that the rating market lacks competition, (Brand, 2005; Deb et al., 2011; Partnoy, 2001) and that consequently, the big three CRAs (S&P, Moody's and Fitch) pose an unfair competitive force against any new CRA entrants (Nazareth, 2003), participants expressed concerns at the proposed regulatory measures to increase the number of CRAs. The aim of increasing the number of CRAs in the market was perceived as naive by participants and not likely to work.

The argument was that competitiveness in the ratings market was largely driven by reputation and track record (consistent with the reputational capital view of credit rating agencies – Bonewitz, 2010). Any new CRA entrants without the requisite track record and reputation would find it difficult to establish themselves as rating users would shun them in favour of the more trusted incumbent brands. Regulators therefore have to think about practical supportive measures of not only introducing more CRAs, but ensuring that such new CRAs got customers. The idea of increasing CRA competition was also challenged by some scholars (Becker, 2011; Becker & Lagace, 2009; Becker & Milbourn, 2011; Bolton et al., 2012; Camanho et al., 2010) who concurred that more competition could inversely affect ratings quality by fuelling ratings inflation. This owed to the fact that if the issuer-pays model persisted, issuers would still be driven by the need for more positive ratings as a way of lowering their cost of debt.

If the market was extremely competitive with many CRAs vying for business, there would be no stopping CRAs to rate favourably so as to win more business and retain clients. This could erode the value of ratings and have a negative impact on ratings quality and in turn affect operations in the market.

Regulators therefore ought to seriously rethink their strategy of addressing competition problems in the ratings market in light of the above comments. The European Commission had originally mooted the idea of introducing an EU-sponsored CRA, perhaps as an attempt to weaken the perceived power of the US-based CRAs over the EU market. This idea was however shot down by participants who argued that one of the key challenges in the ratings market was that of conflicts of interest. If the new CRA was to be sponsored by the EU, it would suffer from similar conflicts of interest arising from its allegiance to its funders (the EU) and would therefore be a retrogressive step if on the other hand the EC wanted to tackle conflicts of interest among incumbent CRAs. Similar sentiments were raised in extant literature (see for example Paudyn, 2011). IN2 emphasised the challenges that could be associated with the establishment of an EU-sponsored CRA:

> *"It's independence of thought, independence of action. You would have to have some doubts that an EU-sponsored agency would look at the ratings of sovereign countries in Europe as critically as Moody's or S&P might, because if you are being paid by Brussels, or whatever better term, you're not gonna downgrade Belgium! I have a feeling you wouldn't be in the job for very long"*

An EU-sponsored CRA would thus undermine the very principles that the new regulations were seeking to introduce. Notwithstanding the traditional view of conflicts of interest, there was a view that investors (or their agents) were conflicted as well in terms of whether they wanted genuine ratings that accurately reflected the true standing of their firms or they simply wanted higher yields and consequently the high ratings to bring about such yields. This point was underscored by IN2 who argued that:

> *"I think one of the things that haven't been appreciated or explored on the whole crisis is the pressure from investors to get the yield which drove fund managers and banks down the route of if its rated we'll do it because if we don't do it, somebody else will. I'm sure it this disappeared quickly in 2008-9 but even since then it's come back again people keep popping their heads up now saying what can we do, no extra risk how could we get some more yield"*

The above point suggests that investigations on conflicts of interest need to be broadened if a holistic picture is to be developed. The insinuation above was that the financial incentives possibly overshadowed objectivity when it came to credit ratings. Market participants viewed the compliance requirements stipulated by the new EC regulations as being prohibitively burdensome, costly and likely to repel new CRA

entrants rather than encourage them. A similar observation was made by Jones (2004) who drew parallels with US regulations, arguing that the SEC in its attempt to increase competition, instead created a barrier to entry through its difficult-to-attain NRSRO designation. Regulators therefore need to carefully consider the uniqueness of the CRA landscape and reconsider the role of competition in this area. There could be detrimental issues of arbitrarily introducing droves of CRAs into the rating industry, notably, in the UK. The next section discusses voice metaphors and their implications for this study.

7.2.3 Voice metaphors

The voice metaphor was used here to denote the various and often polarised views or perspectives on credit rating agencies, credit ratings and the role of the EC regulations in the market. There were 12 metaphors in the voice category. These were further broken down into four sub-categories denoting (i) the communicative nature of credit ratings; (ii) the subjective nature of credit ratings; (iii) the mechanistic behaviour that characterised the rating process prior to the 2007-8 crisis, as well as (iv) the mystical view of the rating process. The four areas are all discussed below. Credit ratings were (and still are) perceived to be the default signifier of a rated entity's viability. To that effect, participants particularly noted their prominence as "*key parts of the communications channels.*" Higher ratings suggested a well-governed company with sound structures and stable financial projections. Despite the traditional view of ratings, participants perceived both the rating process and the regulation thereof to "*lack transparency.*" It was felt that the rating process was not straightforward, and lacked clear guidelines of what went in; how it was processed and with what outcome. Similarly, the regulatory framework introduced by the EC was said to be high-level and vague in a lot of respects for example on how the local monitoring would be done and by whom among other questions. Participants felt that there were a lot of unknowns when dealing with both the CRAs and the regulators. As discussed earlier, the regulations did not exactly outline the future role of different players, particularly CRAs. This fuelled anxieties particularly when there were insinuations of reduced regulatory-reliance on ratings. With CRAs having built such huge empires, it felt as if their very survival was under threat. Their expressed interest in actively engaging with the regulatory process could therefore be attributed to a keen attempt to influence regulations endogenously.

The view of lack of transparency in credit ratings echoed conclusions reached by several studies in the area of ratings (see for example Delamaide, 2008; IOSCO Technical Committee, 2004; LaFrance, 2009; Manns, 2009) in which all concurred that the rating methodologies were opaque and made it difficult for market participants to judge the quality of rating outcomes. Further, ratings themselves were said to be difficult to understand as echoed by IN2 who asserted:

> *"I think getting back to a clearer definition of what the ratings mean and the comparability of ratings and not giving this false impression that things which sound the same and the same and the risks associated on some scale"*

The suggestion from the above observation was for a clearer delineation of ratings. Linked to the "*lack of transparency*" in the rating process, participants argued that rating analysts tended to be less experienced compared to their issuer counterparts and consequently were "*bamboozled*" by the depth of knowledge that issuer staff possessed in relation to credit ratings and the rating process. This allegedly may have led CRA analysts to overlook certain loopholes in the issuing information presented to them, ostensibly because they may have lacked confidence to question their more experienced issuer counterparts. Despite ratings being a key indicator of the worthiness of the rated entity, participants argued that ratings were "*not forward-looking*" as they were based on historical performance and lacked deeper predictive powers. This was particularly concerning as ratings were used to drive future investment decisions.

Participants argued that ratings were "*not the gospel truth*" rather, that they were "*just one part of the equation.*" This reaffirmed the argument that ratings were only meant to be points of comparison, not an end in themselves. These sentiments were raised in the backdrop of over-reliance on ratings by market participants and regulators, raising questions on why ratings users had over-relied on ratings in light of the nature of such ratings. The above sentiments perhaps applied more to unsophisticated, smaller investors who may not have had the resources to conduct their own full scale due diligence. As discussed earlier, ratings are opinions, with significant subjective elements and should be carefully evaluated before decisions are made based on their contents. The treatment and usage of credit ratings in the period leading up to the 2007-8 crisis does not evidence careful regard to the usage of ratings. Instead, users seem to have blindly used ratings.

The "*mechanistic behaviour*" of participants when using ratings denoted a rigid approach that only relied on the rating symbols and failed to apply human judgement to broader environmental issues in the market. As a result, ratings were said to have been used in a "*production line*" fashion with the focus on volumes where analysts adopted routine processes, almost treating the rating process as a mass market activity. The danger was that environmental influences were ignored, particularly as most rating users had ratings "*hard-coded / hard-wired*" into their investment guidelines. The driver behind the choice of CRAs was therefore complex, denoting the risk appetite of the different investors as IN1 asserted:

> *"…some of them will have predetermined requirements, it can vary, some will give us full discretion, but many of them will prescribe what sort of ratings are required. So we are merely reflecting their risk appetite which can be different from our own risk appetite in reality………… by and large, if that's what the client wants, that's what the client gets and there is no real incentive for us to persuade them to take something which might seem more risky and may not work out"*

Such hard-coded investment guidelines emphasised ratings from particular CRAs, ostensibly based on their reputations. What became key was to have the rating, rather than look deeper into what the rating actually meant. Consequently, ratings ceased to be meaningful, failing to indicate the underlying asset risks, particularly in structured products.

Lastly, because of the perceived "*lack of transparency*" surrounding the rating process and associated methodologies, there was a mystical view of the rating process as a "*black box*." Black boxes are considered to be functionally important although what happens in them remains a mystery. Likewise, participants felt that the rating methodologies were opaque and that there was no clearly defined process linking what went in, with what eventually came out the other end. The myriad of inputs fed into the rating process (incorporating quantitative and qualitative information) typified a "*melting pot*" that gave out an outcome which users felt they were not capable of judging.

The lack of clarity on the regulatory process led participants to label it as "*sheer bloody bureaucracy"* denoting their exasperation on what they perceived to be ill-thought out regulations. OP2 summarised the frustrations as follows:

"I think that the form of regulation taking place is excessive and incompetent….. It seems to me that that is highly unnecessary. A rating agency is a seller of information and it is up to it to justify that its ratings are worth listening to. The additional benefits obtained by making them register and be approved and so forth seems to me to be unnecessary. The cost of doing all that seems to be high. The costs are only going to be borne by issuers because the investors are looking for a return after all their costs, the rating agencies need to be profitable in order to remain as rating agencies, the only person who is going to pay is the issuer either by coupon or by paying the issuer directly"

The above sentiments asserted the reputational capital view of credit rating agencies whose main argument was that CRAs' biggest assets were their reputations such that when these were compromised, such CRAs could lose business (Bunjevac, 2009; Mathis et al., 2009). If this was the case, the argument was that the market would judge CRAs and vote for more reputable ones. This would render external regulation unnecessary as CRAs would self-regulate. This point was emphasised by OP2 who argued against regulation:

"It seems to me that that is highly unnecessary. A rating agency is a seller of information and it is up to it to justify that its ratings are worth listening to. The additional benefits obtained by making them register and be approved and so forth seems to me to be unnecessary. The cost of doing all that seems to be high"

Following the above logic, there was therefore a feeling that the regulations were bureaucratic, excessive and unnecessary. The following sections discuss implications of the above observations.

7.2.3.1 Implications of various opinions on the regulation of CRAs

The perceived disconnection between the heavy reliance on ratings on one hand and their subjective nature on the other, suggested that users needed to be fully educated on the nature and value of ratings (White, 2001, 2010a). Ratings users may not have had a sufficiently detailed appreciation of what constituted a rating and to what extent they should have relied on them.

The entrenchment of ratings into the securities market was partly explained by the "*hard-coding / hardwiring*" process (see for example Deb et al., 2011), and the resultant "*production line*" or "*mechanistic behaviour*" which suggested that ratings became so embedded in the securities market that users' senses of judgement lapsed as the process became highly routinized and mechanistic.

Machines only act on coded instructions; they do not break away from coded routine, nor exercise judgement or discretion with regards to the tasks to be performed. This routinised approach to ratings was perceived to take away the moderating judgement of human logic which needed to be a key part of ratings. It can be argued therefore that the mechanised / routinized approach to both the generation and use of ratings may have been partly a result of regulatory reliance on ratings (Fennell & Medvedev, 2012; Papaikonomou, 2010). Regulators need to address the mechanisation of ratings to avoid treatment of ratings as mass market products.

Expectations of what CRAs should do are conflicted. On one hand, CRAs are expected to provide timely rating transitions through speedy updates after each rating migration. On the other hand, users expect market stability which would be negatively affected by frequent upgrades and downgrades. This was clearly captured by OP3 who argued that:

> *"..one thing that I worry about at the moment is that there is a lot of criticism about how slow it has been for some rating agencies to downgrade private sector credit and that this has led to inflated asset valuations and so on. At the same time, some of the same people have criticised rating agencies for being so fast to downgrade sovereign states and I'm afraid that I don't think it is easy to think that both sets of views are right.."*

To try and strike a balance, CRAs rate 'through-the-cycle' taking an average position in the long term (Altman & Rijken, 2005; Mizen & Tsoukas, 2009). This tension needs to be resolved as it may have ramifications on the approach taken by credit rating agencies in trying to balance between the two conflicting demands on their services. There have always been contentious views on whether to regulate CRAs on one hand, (Crawford, 2010; Hall, 2009) vs. those promoting less CRA regulation (Nichols et al., 2011; White, 2010a). The various opinions and diverging guidelines on how to approach the ratings market particularly relating to regulation are consistent with the "depiction of the construction of law as succumbing to many voices" (Eldeman, Uggen, & Erlanger, 1999, pp.407) which invokes a social constitution of the regulatory process and suggests possible links with endogenisation of regulation.

The social constitution of regulation (see for example Malloy 2010) portrays regulation as a negotiated and socially-constituted outcome. This is consistent with the endogenisation theory of regulation which argues that regulated entities are inherently interested in contributing to the regulation formulation process so that it becomes internalised.

Both the social constitution of regulation and the endogenisation theory are central to this study. They are a break from the traditional 'top-down' exogenous view of regulation where the regulated entities are treated as silent in the regulation formulation process (see for example Baldwin, 2008; Baldwin & Cave, 1999; Baldwin et al., 2012).

The endogenisation approach is particularly poignant considering the fact that despite clear regulatory efforts to address alleged market failings and curb CRA powers, regulators did not articulate what the continued role of CRAs would be when the EC CRA regulations are fully implemented. This naturally raises concerns among CRAs on whether this process marks a beginning of the end for them or whether their current empires will be threatened by as yet an unclear new regime. Naturally CRAs would be keen to engage with the regulatory process so that they shape the new dispensation. The involvement of CRAs and other players in shaping the regulatory process culminates in a social construction of regulatory outcomes (see for example Malloy, 2010). In the social constitution of regulation or the endogenous regulatory view, the regulated entities are active in co-determining the regulatory outcome (Becker, 1985; Ellig, 1991). This central theme will be discussed in more detail in sections 7.4. Section 7.2.4 discusses the next category of metaphors depicting relationships, power and influence among different market participants in the rating industry.

7.2.4 Relationship, power and influence metaphors

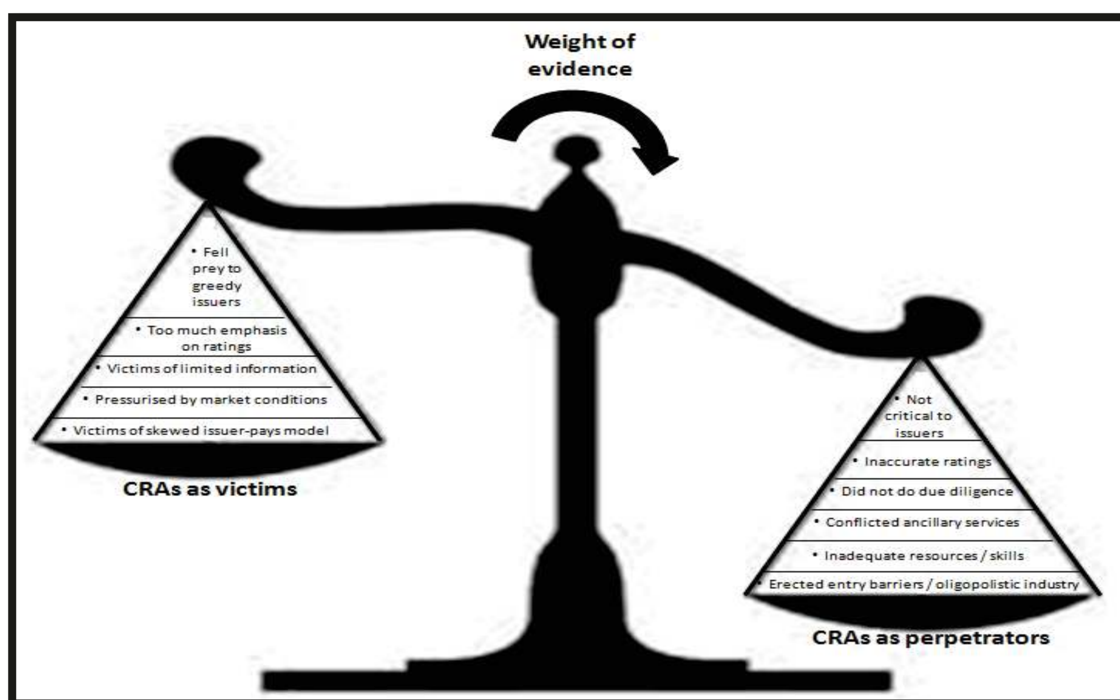
There were 13 metaphors in this broad category, evoking strong animate and inanimate depictions of CRAs and the power dynamics in the rating industry. Metaphors in this category were further split into (i) CRAs as victims; (ii) CRAs as agents; (iii) CRAs as mechanistic agents and (iv) metaphors of power and domination.

7.2.4.1 CRAs as victims

The view of CRAs as victims of a systemic failure portrayed them as having played a small part leading up to the crisis but ostensibly inherited most of the blame. This view presented CRAs as "*easy prey, usual suspects or scapegoats.*" Arguably, this depiction stripped CRAs of any power and rendered them easily susceptible to blame and therefore convenient fronts to take the blame when things went wrong. The view of CRAs as vulnerable prey portrayed them as devoid of any meaningful power or responsibility for the messages they transmitted.

It was interesting to note the contrast between the perceived unfettered power that CRAs were perceived to wield in determining the future direction of rated entities on one hand, (see for example Partnoy, 2001) and the view of them as "*easy prey,*" unable to defend themselves against vilification on the other hand. Scholars argued though that on balance, evidence placed CRAs as more of perpetrators than victims in the 2007-8 debacle (Ryan, 2012). The balance of evidence is summarised in Figure 10 below.

Figure 10: CRAs - victims or perpetrators?



Adapted from Bilaterals.Org (2012); Ryan (2012)

As shown in the diagram above, more evidence suggested that the bulk of failures arising from credit ratings were within CRAs' domains of control and therefore preventable. The view of CRAs as victims was therefore partly but not entirely true when viewed from the above angle. The view of CRAs as agents portrayed them as "*messengers, watchdogs, eyes and ears, guard dogs, and gatekeepers*" suggesting that they "*slept on duty*" and thus failed in their role as custodians of crucial market information (Kraakman, 1986; Lombard, 2008). This later depiction suggested that CRAs had power and influence to sanction the flow of information or to prevent wrong doing or unlawful access into the securities market. Interview participants also argued that CRAs failed in their information intermediary roles as OP2 argued:

> *"..I have some sympathy with the rating agencies but they are paid to be cynical and they weren't"*

As agents paid to scrutinise information passed on to them, CRAs failed to do this diligently. As extant literature shows, CRAs were said to have failed the information intermediary role and contributed to the crisis (Alcubilla & Pozo, 2012; Fennell & Medvedev, 2012). Cassese and Casini (2012) portrayed CRAs as honey birds, actively signalling to bee hunters, the location of honey bees' nests. Unlike Credit Rating Agencies, honey birds only get their reward if they successfully lead the bee hunters to the honey. CRAs seem to have been rewarded despite allegedly leading rating users astray. In both instances, CRAs played an active signalling role. There was a salient weakness of the depiction of CRAs as sentries of whatever kind. Sentries are usually posted at gates to control movement into or out of a controlled zone. If CRAs fit this bill and were expected to play such a role, then the fundamental weakness is that they could miss the errant behaviour of those already inside the controlled zone as their focus would be primarily on vetting new entrants into the controlled zone.

A further loophole depicted in the sentries' metaphor was that it placed too much responsibility on the sentries, striping the entrants of any responsibility or culpability as if they did not have free will. These metaphors therefore deserve further scrutiny as there could be multiple connotations from their use on CRAs. The agency metaphors still gave CRAs some leeway as messengers are not entirely to blame for the messages they convey, hence the adage "*do not shoot the messenger*." If messengers distort the conveyed messages or misinform, then they bear some responsibility for the consequences of their inaccurate messages. This seems to have been the case with CRAs leading up to the crisis. Various scholars have previously depicted CRAs in a number of different ways such as information intermediaries (Miglionico, 2012) and information brokers (Leyens, 2011; Walker, 2010) among others.

While the above views were slightly different, they reasserted the agency role of CRAs, acting on behalf of their principals, connoting the role of merely interpreting and clarifying the information in their charge. In reality, CRAs did (and still do) much more than simply convey messages and therefore the above depiction of them as mere messengers fails to succinctly capture what they do. Issuers pay CRAs not to merely convey messages (ratings). CRAs generate the ratings from information presented by issuers and are thus not mere messengers. Through their ratings, CRAs wield a lot of power as their ratings can make or break rated entities.

The description of CRAs as messengers therefore does not seem to accurately fit the real nature and role of CRAs (Friedman, 1996). In this same metaphor category of relationships and influences, CRAs were depicted as inanimate and mechanistic agents (*"fire alarms"*) whose function was to detect danger and sound the alarm. This depiction perhaps downplayed the role of CRAs in the causes of the 2007-8 crisis as their job would have been complete after sounding the alarm, on time. IS9 emphasised this point:

> *"I don't think you can blame rating agencies for it. I don't think they have done a great job but I think it's a bit like blaming your fire alarm for your house burning down when you have been having fires inside the house. Obviously it could have been reported earlier, but it's not their fault"*

Several questions arose from the above argument. Firstly, whether the depiction of CRAs as "*fire alarms*" was an accurate one, and secondly, if the description fitted, whether CRAs sounded the alarm prior to the 2007-8 crisis, and if they did, whether this was timely enough for those protected to safely leave the scene soon enough. The implication here is that failure to sound the alarm on time signifies a malfunction on the intents and purposes of the fire alarm and therefore suggests that CRAs may not have worked as well as they were supposed to. Further, the depiction of CRAs as "*eyes and ears*" again reinforced their detection role, laying a responsibility on CRAs to keep vigil over securities market issues, a role that CRAs allegedly failed to carry out diligently as has been discussed earlier. On all accounts above, there was a perception that CRAs indeed failed to fulfil their mandate as connoted by the perceived roles discussed in this section. The issue of power dynamics in the securities market deserves further scrutiny. Just to touch on a few points within the remit of this study, the competitive landscape was perceived by participants to be in need of levelling as it was said to be currently "*uneven*". This can be read from several viewpoints.

Firstly, as one participant stated, CRAs competed on an uneven footing characterised by "*Davids and Goliaths.*" This suggested power imbalances possibly based on resources, market regulation and competitive advantages in favour of incumbent CRAs. This has direct links to the previously discussed "*catch-22 situation*" that disadvantaged new CRAs from accessing traditional markets owing to their alleged lack of credibility (Deb et al., 2011).

This problem was partly meant to be addressed by the regulations but as discussed in section 7.2.2.3 above, simply introducing more CRAs into the market would not address the lack of competition or the uneven playing field. Regulators therefore ought to rethink the problem of lack of competition and formulate much more targeted strategies. In an earlier study, Goshen (2006) argued that securities regulations played a pivotal role in creating a level playing field ensuring that there was fair competition. The challenge for regulators was to ensure that such regulations did not impose unnecessary costs to the regulated market.

The second possible inference from the above "*levelling*" metaphor could be associated with the unchecked power that CRAs were said to have wielded over the market while at the same time lacking accountability to act as a check on such power (Partnoy, 2009; White, 2009). This suggested an uneasiness in the market regarding private, profit-making quasi-regulators wielding such influence but lacking democratic accountability mechanisms to hold them to account (Kerwer, 2002; Partnoy, 2001).

The third inference to be drawn out of the metaphor above may relate to the perceived relationship between regulators and the regulated entities. The use of "*Davids and Goliaths*" and "*uneven ground*" in this instance could suggest the perceived inequalities in the regulator-regulated relationships and could ferment ill-feeling particularly if the regulated entities felt excluded from contributing to the regulation formation process. Unevenness in this case could take away consensus and usher in a dictatorial regime which seemingly was being resented by the participants in the study. Alternatively, the metaphor could connote the uneven competitive landscape characterised by bigger incumbent CRAs (the Goliaths) and the smaller entrants (the Davids). The next section discusses the implications of the relationships, power and influence metaphors to the regulation of CRAs.

7.2.4.2 Implications of agency relationships, power and influence metaphors

There were several poignant issues embedded in the metaphors in this category. Firstly, the fact that a lot of relationships in the securities market involved agents not acting on their own behalf, but on their principals' interests was said to be a major weakness in the industry. This was highlighted by IN8 who observed that:

> *"..it's still a fundamental weakness that lies in the financial markets. Too many of the people who make investment decisions are representing other people's money and have short term interests.."*

The implication was that the traditional principal-agency problems apply to this market, questioning the commitment of the agents and how possible conflicts of interest were managed. Secondly, there was a perceived need for clarity on the role of CRAs as well as a delineation of the expectations from CRAs' different stakeholders. During this study, participants and CRA representatives did not agree on the role of CRAs, suggesting a need for clarity in this area. Lack of clear role-definition and expected outputs meant that the market was not able to judge when CRAs failed to deliver as per their obligations. Cassese & Casini (2012) portrayed CRAs as 'honey birds' who signal the location of honey bees' nests to honey hunters. In doing so, the honey birds neither represent the hunters nor the honey bees, but altruistically do so for the remnants of honey cobs left after the hunters' harvests. This imagery raises questions on CRAs' loyalty to investors as private profit-seeking commercial entities. Following the analogy in the honey birds metaphor, CRAs would naturally align with issuers since they pay for their services. Strictly speaking, CRAs are mandated to ensure the protection of investors, a mandate which causes conflicts particularly when the CRA funding model is considered. The implication here is that the fundamental problem in ratings lies in the funding model.

The third point related to the uneven relationships amongst CRAs; (between incumbents and new entrants), as well as between regulators and those regulated. This last point is central to this thesis as it considered the traditional role of regulated entities in the formulation of regulations, considering more inclusive arguments that pitted the regulated as co-creators of new regulations. This is discussed in more detail in section 7.4.3. The next category of metaphors relate to movement.

7.2.5 Movement metaphors

Movement metaphors were used by participants to depict the "*fluid and flux*" state of the securities market regulatory environment. On one hand, participants perceived regulations to be swinging like "*a pendulum*" between extremes of no regulation on one end (as was typical of the ratings market prior to the 2007-8 global financial crisis - Lynch, 2009), to possible over-regulation on the other end (as is being alleged to be the case in the post 2007-8 crisis - Bruno & Claessens, 2007; Maris, 2009; Nichols et al., 2011). IN2 emphasised this swing of regulatory reactions thus:

> *"I think like all these things there is always a flow between less and more and I think at the moment we are into the more mode. I'm sure given time we'll ease back to a less mode as it were. It's inevitable it happens to some extent. It's tempting to think if we get things exactly right then we can maintain a proper balance"*

The implication here was that participants did not perceive a state of equilibrium in the regulatory process, but saw some "*reactive*" attempts by regulators to either heighten regulatory pressure or tone the regulations down, in response to market events. Typically, participants viewed regulatory efforts as reacting to market events with regulators said to be "*closing the gate after the horses had bolted*." This somehow suggested that regulations were lagging market events, almost being late in addressing market problems.

The perceived "*fluidity*" or state of "*flux*" referred to above, denoted a perceived lack of stability which caused anxiety among market participants. Participants perceived "*ratings to be tighter since the crisis*," with CRAs said to be "*more uptight*" in their rating approach, a view that has been echoed by some researchers (Baghai et al., 2011; Blume et al., 1998). Extant literature on CRA responses to crises suggested that CRAs tended to over-compensate after crises, with ratings moving from a more optimistic regime towards a more conservative rating regime (Baghai et al., 2011; Blume et al., 1998).

A second strand of the movement metaphor captured the "*reactive*" nature of the EC regulatory process and regulators in general. Participants felt that regulators "*weren't up to speed*" suggesting that they were not quick enough to react to market developments in a timely fashion. Consequently, their regulatory responses were said to be "*reactive and kneejerk,*" lagging behind "*aftershocks*" of the crisis (Becker, 2011; Coffee, 2010; Fisch, 2010; Pistor & Xu, 2005). Referring to the Glass-Steagall Act in the USA, Lightfoot (2003) lamented the fact that the regulations at the time were reactive and not well-thought through, resulting in burdensome effects on those regulated. Parallels can therefore be drawn between the American Glass-Steagall experiences with the EC regulations. This parallel triggers questions on whether the EC regulatory process may follow the same lines, if so, whether proactive measures can be taken to circumvent any negative impacts from the regulatory process. On a separate issue within this broad category of movement metaphors, participants opined that "*regulators had run off with the headlines*."

This metaphor suggested that regulators were perceived to have taken a populist approach, shifting their perspectives and following media headlines as opposed to taking a long-term view of the problems in the market. The suggestion was that the regulations were "*tick-box*" in their approach, perceived to be driven by a desire to win votes more than a real interest to address the problems in the market. This view was said to be manifested by the many changes that had been made to the regulations since their inception in 2009 (see for example the amendments resulting in CRA2 and CRA3). The suspicion was that regulatory amendments were largely reactions to media issues and therefore populist in nature. Participants opined that a fundamental motivation for regulators to take a populist approach could have been the fact that the terms of office of the politicians behind the regulatory agenda were limited and consequently, such politicians tried to go for high media impact reforms during their limited terms of office.

The definition of 'high impact' could be subjective and short term but as long as it left a legacy for the politicians and regulators concerned, they may not have carried out a detailed impact assessment on the long term impact of the resultant regulations. The section below considers some of the implications drawn from the movement metaphors above.

7.2.5.1 Implications of movement metaphors

The credit rating market is very dynamic and there is need for regulators (and regulations) to keep up with this dynamism (Djelic & Sahlin-Andersson, 2008). Further, regulators need to take a holistic and long term view of market issues to avoid short-term regulatory changes that may cause market instability. The perception that regulatory efforts seemed to be lagging rather than leading market activities suggested that regulators needed to regulate for the long term, not respond to short-term popular media issues. A balanced approach to regulation should see the formulation of stable regulatory provisions that seek to avoid extreme situations of under-regulation on one end or over-regulation on the other. Regulators therefore need to address the perceived "*pendulum regulatory swings*" which cause anxiety and market instability. The next category of metaphors depicted the perceived false realities in the ratings market and is discussed in more detail below.

7.2.6 Masks, appearances and pretence metaphors

This category contained 8 individual metaphors which denoted participants' perceptions of superficial activities in the ratings market which were said to be masking the true reality of issues on the ground and instead, portrayed a masked reality. The implication was that there were claims made in the market which were not real and needed to be explored in greater detail if one was to determine the true nature of events on the ground. Metaphors in this broad category were further divided into three sub groups: (i) perceived futile regulatory efforts; (ii) perceived masked realities and (iii) perceived superficial changes. These are individually discussed below.

7.2.6.1 Perceived futile regulatory efforts

There was a sense that regulators were (and still are) perceived to be "*toothless bulldogs.*" The insinuation was that despite the new regulatory structure promoting ESMA as the new CRA regulator covering the EU, ESMA was not perceived to possess enough legal or infrastructural clout to command compliance across the EU (see for example (Rennison, 2012). As an example, the Level 3[13] regulatory requirements compelled ESMA to develop market guidelines to be implemented by the various competent supervisors in each EU member state. The downside was that despite these guidelines offering a consistent approach across the EU, the guidelines were non-binding to individual member states and operated on a 'comply-or-explain' basis. ESMA still relied on individual market supervisors to carry out the ground-work and provide day-to-day oversight of market operations in their member state jurisdictions. ESMA's relationship with individual market supervisors was not contractual, implying that such market supervisors could exercise their discretions, further weakening ESMA's hold as a central EU securities regulator. This was the same situation that ESMA's predecessor (CESR) faced hence there did not seem to be a perception of any meaningful change in this area. While there were broad high level regulatory stipulations, the finer details still left loopholes that could be exploited by errant market practitioners.

[13] *Level 3 guidelines are part of the four-level regulatory guidelines initially proposed by the Lamfalussy committee. The level 3 guidelines require ESMA to set up a consistent and efficient supervisory framework for financial supervision backed by Union Law to be implemented by competent authorities or financial market participants in each of the member states. The guidelines are not legally-binding but operate on a 'comply or explain basis' with Financial market participants required to report on whether they comply or not. (ESMA, 2012)*

The fact that ESMA are a pan-European body with no direct representation in each of the EU market states made them unelected non-Majoritarian regulators (Kerwer, 2005b) whose legitimacy within each market was questionable. As a pan-European Union regulator, ESMA were not directly accountable to any electorates in member states, further posing legitimacy challenges that could undermine their authority. The futility of some of the regulatory efforts were said to be exacerbated by a perceived misdiagnosis of the market problems in the first place. This meant that the resultant prescriptions would most likely fail to work, further engendering little trust among market participants on the ground. An example cited by participants was the futile objective of increasing competition among CRAs as noted by CR1:

> *"..Clearly there are 3 major rating agencies but that's the investors' choice. You have to look at the model; the issuer-pays model. If the market was more fragmented, could the issuer-pays-model really work? I don't know if it could because obviously it's expensive to maintain the analysts, tools, procedures and all of that.."*

Participants did not seem averse to the introduction of more competitors in the ratings landscape per se; rather, they were sceptical about the approach taken to introduce such competition as highlighted in the "*catch-22*" metaphors earlier in this study. Commenting on the same issue of CRA competition, OP1 pointed out:

> *"Investors need to choose a name that they are comfortable with, someone with a good reputation. I do believe that there needs to be more competition but you don't just introduce a new player into this market and hope that they will be immediately accepted"*

Participants viewed the initiative of introducing more players into the ratings industry as "*falling flat on its face*" owing to the fact that the CRA market was not one amenable to the general laws of competition. This owed to the "*catch-22 / chicken and egg*" situation discussed earlier in section 7.2.1. To this end, participants argued that increasing competition was unnecessary and likely to affect ratings quality. The majority of participants in this study felt that there was no need for more competition as underscored by OP6 below:

> *"I mean three agencies is enough, think of big banks in the UK, its 4, often the market won't support that many more people. 4 or 5 tends to be optimal. I think you would have to give some proactive help a new entrant to the market or help the likes of DBRS or Egan Jones or JCR to have a more established European presence"*

IN8 added to the above by saying:

> *"I think at the moment there is sufficient competition for mandates to make sure that the rating agencies are kept on their toes..."*

It was felt that increasing the number of CRAs would most likely fail to achieve the desired effect. As CRAs competed for business from issuers, there was a concern that more competition could force CRAs to issue more favourable ratings as a way of competitively attracting issuer customers, a situation that could fuel ratings inflation and drive down ratings quality. IN9 put this clearly as:

> *"I think quality would go down. I think it's better to have higher quality. I think that's what the pitch would be about. People will pay more to get good information. I think people have realised that they can't cut corners"*

The issue of lack of competition among CRAs therefore needs careful review to determine the optimum level of competition that the market can sustain before ratings begin to be eroded as CRAs competitively vie for business (Ryan, 2012). Understandably, there were opposing views arguing that CRAs' reputations were far more important and would act as safeguards against the temptation to offer more optimistic ratings as a way to win business (Bonewitz, 2010). Notwithstanding the above views, research evidence from studies conducted to determine whether CRAs' ratings responded to competition suggested that CRAs did respond to competition by rating more favourably when under competitive pressure (Becker & Milbourn, 2011; Bolton et al., 2012; Camanho, Deb, & Liu, 2010b). This therefore means that the concern of increased competition fuelling ratings inflation is real, not imagined.

Evidence from this study indicated that the decision on which CRA to use did not rest with issuers, but lay with investors and other rating users targeted by issuers. In some cases, investors had very clear investment mandates which stipulated what specific ratings were required as part of their prescriptive decision making criteria. An example was given by IN4 who said:

> *".. currently, this could be changed but currently you are only allowed to invest in investments that have counterparties that have certain ratings from S&P and Moody's and on the issuance side we have to maintain specific ratings with Moody's and S&P as well"*

The above sentiments suggested that despite having more CRAs in the market, some investors would not even consider them unless their investment guidelines changed to recognise these new entities.

This further underscored the fact that the current strategy of just adding more CRAs would probably not work. Regulators need to target their efforts at the real market drivers by addressing the prescriptive investment guidelines that seem to restrict CRA choice amongst investors.

7.2.6.2 Masked realities

While this category resonated across a number of other metaphors, participants were largely concerned that a lot of the benefits cited in the promulgation of the regulations were illusory. They argued that regulators were actually masking many unintended consequences, instead, promoting illusions of regulatory benefits. An example cited was the view that "*regulatory compliance was gobbling up budgets*" suggesting that compliance with the new regulations was perceived to be imposing prohibitive compliance costs which may not have been properly captured prior to commencement of the regulatory initiatives. An issuer representative, IS1 summed it up as follows:

> *"..staffing and costs, it means I spend a lot of time with the rating agencies. Every summer with the ratings reviews I'm literally working on it for a good 2 months nonstop, which if you think about the simplicity around it, there is a fair amount of work there.."*

Specifically, the EC CRA regulations were said to be imposing costs on CRAs and consequently raising transaction costs across all participants as IS2 observed:

> *"..it puts the costs up for the rating agencies, those costs are going to be passed on to the issuers..."*

There was a sense that a cost-benefit analysis was needed to evaluate the regulatory efforts and that regulators did not seem to have anticipated the full impact of the new regulations. It can be argued that an inclusive approach, involving regulated entities in the formulation of the regulations would have helped sense-check the proposed regulations, considering costs and benefits to arrive at an optimum regulatory proposal. Such an inclusive approach could take the form of an endogenous approach to regulation which is discussed in more detail in section 7.4. The next section considers the superficial changes alleged to be observed post the EC regulations.

7.2.6.3 Superficial changes

This sub-category was the biggest within this metaphor category, comprising five different metaphor units. There was a very strong and recurring feeling of deceptive practices in the market, manifested through "*box ticking*" bureaucratic processes that in reality were not addressing the core problems in the market. OP2 emphasised this point adding that:

> *"The advantages from the informational side aren't as big as they could have been. The requirement for registration and all that seems to me to be entirely for the birds, it's entirely a bureaucratic process if companies want to buy and pay attention to a rating agency's ratings, that's their lookout, you buy sensible ones that's fine, you buy flaky ones you are not going to do as well, it's up to you to make that judgement"*

Regulatory intervention was therefore viewed as an intrusion into the market. While there was a lot of rhetoric about concerted efforts to change practices in the market, participants felt that the market was "*back to business as usual*" and that the 2007-8 crisis was slowly fading in people's minds.

This suggested that some of the practices that may have led to the crisis may have well been on their way back and because "*regulation was window-dressing*" it was not equipped to tackle such issues. Another metaphor used in this sub category was that of "*packaging*" suggesting the hiding of an object and presenting it in a new form. This was a practice prevalent in periods leading up to the crisis where issuers pooled different types of structured assets, masked the real risk and came up with something much more exciting and seemingly less risky. Questions can be raised as to whether packaging had taken a new form where perhaps different artefacts were being packaged.

An underlying question can be raised concerning regulators' competence to unmask any packaging currently being carried out in the market. Overall, this strand of metaphors suggested that things were not what they seemed in the market. The reason could be complexity which masked reality or it could be deliberate efforts by those concerned to operate in a veil of secrecy for their own ends, most likely to evade regulators. Whatever the reason, those who successfully evade detection through their masks could keep the bulk of regulatory efforts at bay, further questioning the effectiveness of the EC regulations.

7.2.7 Perimeter fence and boundary metaphors

Under the perimeter, fences and boundaries metaphors, participants used metaphors that depicted barriers and boundaries denoting efforts to separate. CRAs were said to be employing "*Chinese walls*" to separate their analysis from commercial activities as a way of mitigating accusations of conflicts of interest. This was consistent with findings in extant literature investigating CRA compliance (Bai, 2010). This change in CRA operations was attested to by IN10, representing the investors' view:

> *"..rating agencies now actively separate their more business-oriented activities from the analysis activities. We are more and more only exposed to the analysis side while our other negotiating colleagues deal with contracts and such like"*

The "*Chinese Wall*" metaphor was derived from the Great Wall of China and became popular after the US stock market crash around 1929. Following the crash, there was insistence on the separation of investment banking from investment broking services.

Participants also used the "*overboard metaphor*" suggesting that regulators were perceived to be overstepping their mandate, employing a "*one size fits all*" approach which was indiscriminate and less likely to be effective. The risk of regulators going overboard was that they could likely micro-manage market operations thereby taking away the ability of market participants to spontaneously respond to issues. The "*one-size-fits-all*" metaphor alluded to the fact that regulators were indiscriminately applying a broad-brush approach to regulation, making broad assumptions about market operations. The background to the above was said to be the previous "*blind use of ratings*" where users indiscriminately used ratings as opposed to using them only as a "*screen*" to complement other sources of due diligence.

The conception of a "*screen*" could be read ironically as masking or hiding reality with a false appearance. An example could be cited when ratings appeared to indicate that underlying rated assets were sound, when in reality they were not. This was particularly so for pooled, structured products leading up to the crisis. The containment metaphors used here connoted divided opinions over power and influence and reinforced the notion of contested regulatory boundaries discussed above. It can be inferred from the above that while regulators attempted to increase their scope, the regulated entities were seemingly pushing back, wanting to retain some freedoms.

Ordinarily, closer engagement between the parties would result in exchanges that would co-determine the regulatory outcomes, giving rise to the endogenous constitution of regulation discussed in more detail in section 7.4.

7.2.8 Dependence and interlinkages metaphors

This category of metaphors denoted the deeper and intertwined relationships inherent in the securities market. The view was that the securities market should be viewed as a holistic entity with different interlinked parts. This implied that when parts of the market were isolated and targeted for regulatory purposes, there could be unintended impacts on other areas of the system. The highlighted metaphors in this category indicated overreliance signified by the "*blind use of ratings*" and the resultant "*herd-like*" behaviour suggesting that market participants tended to band together for strength and support particularly in times of ambiguity. This banding together may have caused stronger bonds to form in the market as symbolised by "*symbiotic relationships*" forcing the market to act in unison (Deb et al, 2011), possibly impairing independence, objectivity and encouraging group think. Since this largely referred to the pre-crisis era, there were questions as to whether these practices had completely died away post the crisis. Some participants were adamant though that the market had since defaulted back to '*business as usual*.'

In light of the inherent conflicts of interest embedded in the 'issuer-pays' model, different alternative CRA revenue models were proposed. One of the commonly cited models was the investor-pays model which unfortunately seemed to have an endemic "*free rider*" problem (see also Fons, 2008). The "*free rider*" metaphor alluded to the fact that the adoption of the investor-pays model could see some entities easily benefiting from freely available ratings thereby disadvantaging those who would have paid for the ratings. OP2 added his weight against the investor-pays model and argued that:

> *"You take the middle size company as opposed to the big companies, that's new to the market, that's in an industry that's difficult to understand, that nobody's heard of, no one will bother to rate them if they aren't gonna be paid for them. The investors aren't going to say oh yes, we want you to rate that one because we will pay you to rate it – they've never heard of it either. So the people who will suffer if you go from an issuer pays to a user pays model are the smaller and more difficult companies who are the very people probably in most need of help.."*

The investor-pays model posed challenges for new and unknown issuers and was also said to be fraught with "*free rider*" problems where it would be difficult to ensure that only those who paid for ratings received them. Nevertheless, there were arguments that the different proposals deserved some consideration and that those responsible should "*not throw away the baby with the bath water*." Overall, the problems in the securities market should not be taken at face value. The intricate nature of the relationships, dependencies and influences between market players suggested that a holistic approach ought to be taken to appraise the market prior to solutions being proffered.

Approaching the issues simply from an economic theoretical perspective could be simplistic as this perspective could downplay the behavioural and sociological influences on / of market participants and impact on the market as a whole. Multiple perspectives should be considered, particularly sociological and behavioural theoretical approaches aimed at engendering an understanding of the motivational, institutional, sociological as well as individual forces at play together with requisite impact on the market. Different theoretical perspectives that help shed light on these issues will be evaluated in section 7.4.

7.2.9 Celebration and crisis metaphors

The last category of metaphors contained 4 individual metaphors depicting the pre-crisis celebratory mood which culminated in the 2007-8 global financial crisis. The exuberance that was characteristic of the market in the period leading up to the crisis was visualised as a "*party*" where "*none dared take the punch bowl away*." The connotation of market participants merrily urging each other raised worrying questions from a number of respects. Firstly, it suggested an over-optimistic attitude in the market where different participants were uncontrollably consumed in the asset bubbles, failing to see the possible downsides of the exuberance in the market. Secondly, the fact that all market participants did not raise any concerns about signs of a possible crisis which now appear to have been glaringly obvious suggests a possible herding culture that had some players' "*fingers burnt*" when the "*panic*" set in.

Credit rating agencies allegedly played a role to encourage the "*party*" through their inflated ratings which further reinforced the optimistic market attitudes. The same CRAs are said to have also contributed to the subsequent downward spiral through sudden rating downgrades which precipitated the loss of confidence in the market resulting in the collapse of all but a few credit facilities (Duan & Van Laere, 2012). Perhaps the biggest question regarding the above metaphors is where the regulators were when everyone was celebrating as well as what role they played in the pre-crisis period. Thirdly, there are questions on whether things have changed significantly for such practices to have completely died away post the 2007-8 crisis. Having discussed the metaphors, the next section explores the implications drawn from the above analysis and discussion.

7.3 Implications of the metaphor analysis

From the metaphoric depictions discussed in the above sections, together with the inferences raised, a number of issues stand out:

(i) Firstly, the frameworks used to investigate issues surrounding credit ratings have been largely based on economic models, possibly downplaying the behavioural and sociological issues shaping individual and institutional behaviours.

(ii) The role of the regulated entities in the formulation of regulation has largely been passive, suggesting an exogenous, top down regulatory approach (Baldwin et al., 2012). Exogenous regulatory approaches see regulations being dictated down to the market without much input coming the other way. In their defence, regulators claim to have consulted various stakeholders prior to the new EC CRA regulations. Notwithstanding the consultations, the idea of consultation may suggest that participants may have been asked for input on an already formulated regulatory agenda which may not have given them much scope for creative inputs outside the consultation terms of reference. This may have hampered participant contributions to the regulation formulation process. Increased participatory approaches suggest that regulated entities increasingly want to participate in shaping the regulatory agenda. Endogenous regulation approaches could potentially offer insightful frameworks for the evaluation of UK-based market participants' reactions towards the European Union Credit Rating Agency regulations.

(iii) Thirdly, the combined effect of the economic perspective to regulation and the non-participation of the regulated entities can lead to a number of challenges when new regulations are implemented. Applying this logic to the EC regulatory environment helps to understand issues therein from a different light.

(iv) Lastly, regulators have failed to clearly articulate the future role of CRAs in the new regulatory arrangements. This may lead to a number of outcomes; that CRAs still see themselves as legitimate gatekeepers and thus continue to exercise their quasi-regulatory powers hence the active engagement. Alternatively, CRAs may be unclear as to whether there is a future role for them particularly with the touted reduction in regulatory reliance on ratings. This may fuel anxiety and force CRAs to come out fighting for their survival. Either way, the active engagement by CRAs and other market players demonstrates a keen interest to engage and shape the regulatory formulation process in a way not akin to endogenous regulation.

The above issues are discussed in more detail below, drawing from the endogenous regulation theory to better shed light on the EC CRA regulatory landscape.

7.4 Endogenous regulation theory and the EC regulatory landscape

At a distance, participants' strong sentiments regarding the EC regulatory provisions could be interpreted as some form of anti-regulatory protest. However, considering the long history of alleged irregularities in the ratings market where previous attempts to self-regulate had not successfully restored market confidence, it is difficult to envisage that market participants would oppose regulation if it was meant to restore confidence in the market. In the backdrop of prolonged accusations of lack of competition among CRAs (Deb et al., 2011; Nazareth, 2003); over-reliance on ratings by both investors and regulators (Coffee, 2008; Papaikonomou, 2010; White, 2010a); opaque ratings methodologies (Iyengar, 2012; LaFrance, 2009; Rousseau, 2009) as well as CRA conflicts of interests (Bai, 2010) to name but a few, it is difficult to see why market participants would be against regulatory efforts which sought to restore market confidence and their own credibility. The failure by the market to address these problems resulted in the loss of confidence in the market. Self-regulation and other initiatives were perceived to have failed to correct the anomalies in the market. Consequently, external regulation would have been the only logical solution to restore market confidence. CRA1 underscored this point and asserted that:

> *"I think there wasn't enough regulation. I think now it's better that there is more regulation. At the same time I think it's important for regulators not to be too reactionary.."*

Closer scrutiny suggested a keen interest by participants to influence the regulatory process possibly as a way to mitigate impact on their own operations. Such an interest was more akin to the endogenous regulation theory discussed in section 4.8.2 (see also Becker, 1985; Ellig, 1991). In the endogenous regulatory approach, regulated entities become actively involved in the formulation of the regulations such that the regulatory outcomes are co-determined (Becker, 1985; Reiter, 1996; Sy, 2012). Analysis of the data from this study indicated strong sentiments by participants against some regulation provisions, arguing that the EC regulations took a narrow scope and potentially missed key issues. On the other hand, there were counter arguments labelling the EC regulations as taking a "*one-size-fits-all*" approach inferring that there were differing views among participants. Further, participants argued that regulators had not consulted in earnest and that they adopted a '*tick-box*' approach. These sentiments indicated that the formulation of the EC regulations was perceived to have been exogenously carried out, with regulators doing this aloof from those regulated. If this was the case, such an approach poses several risks,

(i) As the ratings industry is a highly dynamic and innovative one, regulators cannot possibly keep abreast of developments in the industry while working outside of it, they therefore can potentially miss out on key issues if they do not work closely with industry practitioners;
(ii) By not including regulated entities in formulating the new regulations, this ferments ill-feeling and may cause mistrust which in turn may thwart support for the regulations by those regulated
(iii) The ownership for the implementation of the different regulatory provisions remains foreign and those regulated view regulation as a bureaucratic burden unless they can be brought on board.

There was a perception that the consultation by the regulators prior to enacting the EC regulations was a tick-box exercise. It was argued that regardless of market participants' views as expressed during the pre-regulation consultation exercise, regulators would have gone ahead with their proposals regardless of the consultation outcomes. The seeming negative sentiments against regulation by participants therefore signified an interest to engage rather than be rid of the regulations.

Market participants were concerned that there was lack of clear calibration of what role CRAs and other market participants would play in the new regulatory order.

Consequently, this lack of clarity could cause anxiety and trigger active engagement by CRAs and other players as they attempted to secure their future in the new regulatory arrangements.

7.4.1 Implications of the endogenous regulation theory to the EC ratings industry

While regulatory capture signifies the usurping of regulatory powers for private benefits, this thesis argues that there could be an equally detrimental effect brought about by the exclusion of regulators by a technically complex field characterised by innovative and dynamic development of new products and services of a high information content. The credit ratings industry is information-intensive, requiring regulators to work closely with those regulated, lest they fall behind in their understanding of the market and therefore fail to regulate effectively. This study therefore argues that the revisions of the EC regulations from CRA1 through CRA3 are testimony to the fact that regulators were not fully up to speed in developing the regulatory provisions. This corroborates participants' claims that had they been consulted in earnest and comprehensively, they would have fed their inputs into the process resulting in a better outcome. The proposal therefore is that regulators ought to reconsider their position and adopt a more inclusive approach, particularly when regulating a specialist industry where those regulated know more about their products than the regulators.

7.4.2 The Legitimacy of the European Commission as a regulator

The regulation of CRAs by a pan-European entity (European Commission) across EU member states was perceived by UK-based market participants to raise pertinent questions of legitimacy (Bufacchi, 1994) particularly as the EC's mandate did not emanate directly from grassroots political electorates. The European Commission by its nature is non-hierarchical (Richardson, 1996). Its powers are therefore not drawn directly from electorates in each of the member states, but from the collective contribution of resources by the European Union member states. The EC is not an elected body and therefore lacks the democratic mandate bestowed through the electoral process.

So in a way, the EC's coercive ability can be said to be dependent on the collective will and endorsement of the subscribing member states, making it a rather shaky coalition where some members could pull out, possibly undermining the entire structure (Peters, 1994).

Perhaps the coercive power of the EU and its law-making arm, the EC is based on the desire of member states to be members of the hegemonic EU. This internal constitution of the regulatory provisions within the EU further supports the social constitution of regulation as espoused in the endogenous regulation theory (see for example Becker, 1985; Ellig, 1991). The European Union by its nature is a consensus organ. It's very foundations are built, not on legalistic mandates, but on consensus. It follows therefore that its law-making arm should be cognisant of the foundations on which it is built. In other words, the legitimacy of the EC is based on its continued observance of the will of the subscribing member states. This poses a challenge of how far the EC can assert itself without tipping the balance and rendering itself unwelcome among its constituents.

Radaelli (1997, p.20) asserted that "the role of EU institutions is to catalyse isomorphic processes," the implication is that they themselves are seemingly devoid of the requisite legitimacy to impose models on member states. Nevertheless, organisational theorists argued that legitimacy can still be realised even in the absence of the political electoral mandate. An example of a study investigating legitimacy without political mandates was carried out by Underhill (1995), who concluded that homogenisation of markets catalysed the legitimacy of the supra national system despite the absence of electoral mandates. This view perhaps explains the harmonisation of regulatory practices across the EU, as a way for the hegemonic body (the EU) to entrench itself over member states by replacing their individual structures with an overarching EU-wide regulatory hegemony. Institutional theoretical frameworks therefore help to view the interplay between CRAs, other market players as well as regulators.

While endogenous regulation theory helped explain the strong desire for inclusion in the EC regulatory formulation process by UK-based market participants and CRAs in particular, there was an underlying question of legitimacy, given the nature of the EC as a pan European regulator.

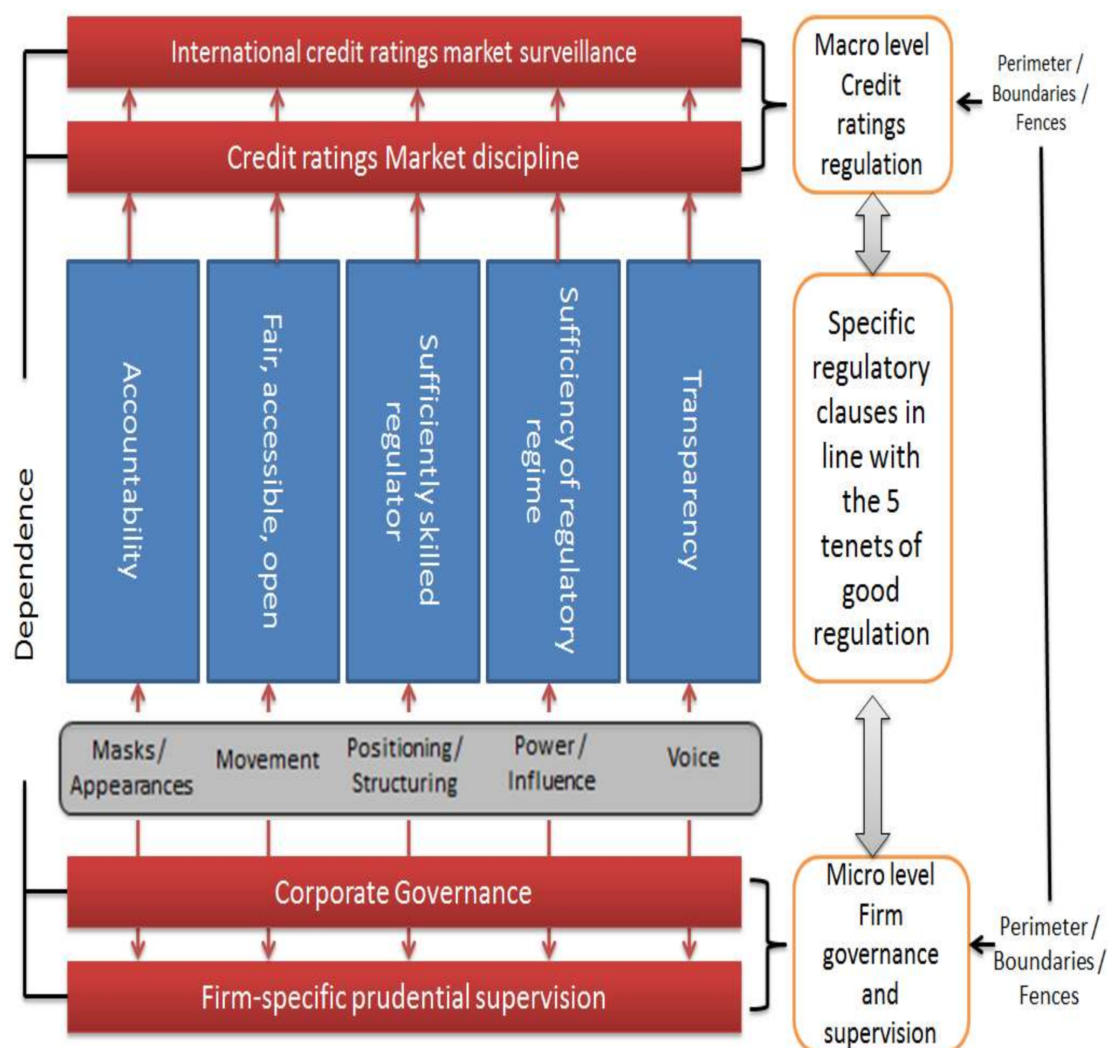
This is an area requiring further investigation, preferably within the frameworks of the legitimacy theory, considering the specific tenets of this hegemonic regulator and how it can seek to sustain itself amid questions of legitimacy. Unfortunately, the limited nature of this study does not permit such an extensive investigation. There is however a close link between the endogenous regulation theory and the legitimacy theory when it comes to the construct of the European Commission as a regulator. Following the above discussions, there are further questions on whether the EC regulations can be judged as good or not. Baldwin et al (2012) and the BRTF (1998) argued that good regulations needed to address 5 key criteria incorporating transparency; accountability; fairness, accessibility & openness; regulatory competence and a sufficient regulatory scope. Further, Davies (2003) presented tools for managing financial crises and divided these into micro and macro level tools. The macro and micro level focus was aimed at ensuring a coordinated approach at both local and broader levels to avoid having loopholes that regulated entities could exploit.

As this study identified endogenous involvement of regulated entities as key in formulating effective regulations, a model incorporating the Baldwin et al (2012) and BRTF (1998) tenets of good regulation; the Davies (2003) macro and micro regulatory scope as well as the Becker (1985) was initially presented in Figure 7. An updated version, including the 8 metaphor categories derived from the interview transcripts. Is presented in Figure 11 below and discussed in ensuing sections.

7.5 Applying the tenets of good regulation test

The following sections consider how the EC CRA regulations are perceived to be measuring up against the criteria in the adapted framework presented in Figure 11. The updated figure below has mapped the metaphor categories to each of the elements of the framework. From the left hand side of Figure 11, the dependence metaphors suggest an intricate linkage between local level (firm level) regulatory conceptions and requisite international arrangements. This ensures that there is a coordinated approach. Further, the perimeter / boundary fences metaphors suggest clear delimitations of the regulatory scope to ensure effective containment at local levels and clear touch points for coordination at international levels.

Figure 11: An updated model of the tenets of good regulation



Adapted from (Baldwin et al, 2012; Davies 2003 and Becker 1983; 1985)

The masks and appearance metaphors have been mapped to the tenet of accountability owing to numerous questions raised in the study about the nature of relationships and perceived power dimensions resulting in lack of clarity on who the CRAs were actually accountable to (see for example Partnoy, 2001). There are implications here for some of the regulatory proposals relating to additional disclosure to ensure CRAs account to the regulators. Such proposals assume that there is capacity to hold CRAs to account through monitoring mechanisms yet in reality, there does not seem to be such capacity on the ground. This further corroborates the mask metaphor; that on face value, regulators make regulatory threats which however lack the requisite backing on the ground.

The movement metaphors were mapped to the tenet of fairness, openness and accessibility of regulatory conceptions to symbolise the conciliatory approach espoused in the endogenous regulation theory espoused in this study. The suggestion was that there should be willingness to co-construct regulatory provisions and maintain an open flexibility to consider alternative regulatory proposals. The metaphor of positioning and structuring conjured images of polarisation between regulators who wanted to exert power over regulated entities yet lacked deeper market knowledge. On the other hand, there were knowledgeable, innovative market participants who seemingly knew more about the credit ratings industry than regulators and yet felt excluded in the regulation formation process. As long as the two groups remained polarised, the exogenous regulation approach would remain entrenched, further alienating regulators from those they regulate. Such a situation would not be too dissimilar to what study participants perceived to be prevailing in the regulation of credit rating agencies within the EU (see for example Lynch, 2008; Levine, 2010). The polarisation pits regulators against those they regulate; ferments mistrust and increases regulatory transaction costs (Ovin, 1998).

The power and influence metaphors were mapped to the scope of the regulatory regime, touching on such issues as regulatory clout, mandate and reach. These attributes are essential for the regulator to assert themselves and exercise control, yet doing so in a way that balances their lack of detailed market knowledge.
Such attributes have to be debated in the context of the legitimacy issues discussed in earlier in this thesis. The metaphor of voices was mapped to transparency, to highlight the complex and varied perspectives at play in the ratings debate plus the need for open dialogue driven by clear motives for the benefit of all in the market. There are deeper theoretical undertones connoted by voice metaphors. Some voices may be loud, drowning others; others may be empty, lacking the requisite backing to make effective representations. The voice metaphor therefore connotes opinions, advocacy and visibility, suggesting that the industry is characterised by diversity of approaches and opinions which need to be proactively harnessed. These issues will be discussed in more detail in the ensuing sections.

7.5.1 Ability to involve regulated entities in the regulatory formulation process

As discussed in 7.4 and 7.5 above, there was a perception that the regulated entities felt excluded from negotiating the regulatory framework. Consequently, there was a perception that in coming up with the regulatory proposals, regulators may have missed out on key market issues. This was said to be partly because the market was dynamic and specialist in nature, requiring regulators to work with practitioners to keep abreast of developments in the market. On the contrary, regulators were said to have "*run off with the headlines*" devising regulatory proposals that were considered burdensome and out of touch. Braithwaite (2007) argued that when regulators lack detailed market knowledge, they may formulate regulatory proposals that go against market logic. This further endorses a more conciliatory approach to formulating regulations (see for example Malloy, 2010). The conciliatory approach advanced in this study is the endogenous regulation theory, encouraging regulators to work closely with those regulated to minimise transaction costs and increase payoffs (Reiter, 1996; Im, Kaserman & Melese, 1989). This study argues that on this account, the EC regulatory proposals therefore fell short of meeting the need for an inclusive regulatory formation as espoused in Figure 11.

7.5.2 Transparency

The depiction of some of the regulatory proposals as '*entirely for the birds'* or '*in the minds of politicians*' suggested that participants felt that the regulations were abstract, divorced from reality and perhaps not sufficiently open to scrutiny. The metaphoric depiction suggested that regulators were not sufficiently open regarding the real regulatory drivers, the proposed process as well as the proposed regulatory outcomes. This may have been because the regulatory process itself was opaque and evolving, with regulators dealing with a dynamic market that was difficult to bottom down. Consequently, there would be changes all the time as was evidenced by the numerous revisions to the original regulatory proposals (i.e. CRA1, CRA2 through to CRA3). It is somewhat ironic that one of the regulatory aims was to address the lack of transparency in the rating industry (Delamaide, 2008; Goshen, 2006; Sy, 2004) and yet the regulatory process meant to achieve that objective was itself said to lack transparency!

In Figure 11, the metaphor categories of voices were mapped to this area to denote the varying interpretations of agendas driving the regulatory process. Because of the diversity of opinions, it was deemed key that the process was open and transparent, allowing for different stakeholders to clearly understand proposals and how they could engage. More research still needs to be carried out to determine the nature and level of consultation undertaken by the EC prior to the enactment of the EC CRA regulations. More importantly, it would be key to find out to what extent, the regulators took notice of the views submitted by the different market participants in the consultations.

7.5.3 Sufficiency of the regulatory regime

Participants strongly criticised the regulatory regime. They depicted the EC regulations as '*patchy*' and likened them to '*closing the gate after the horses had bolted.'* These visualisations of regulations echoed the extant views of Lightfoot (2003)'s depiction of the Glass-Steagall Act of 1934 which was said to be reactive and potentially costly. Similar sentiments were raised more recently by Coffee, (2010) and Becker (2011) who both acknowledged the fact that regulations tend to be chasing market trends, questioning their ability to effectively prevent future crises.

The sufficiency of the EC as a regulatory hegemony perhaps succumbed to the question of legitimacy as posited by Picciotto & Haines (1999) who specifically cited international regulators as vulnerable to legitimacy questions owing to their non-Majoritarian nature and lack of electoral backing (Kerwer, 2005b). The supra national nature of the European Commission subjected its regulatory mandate to the questionable endurance of the European Union and in particular, to the continued subscription of member states.

Its ability to effectively reach down to individual market particulars is questionable as other intra-market contractors may be engaged to effect local supervisions thus compromising the end-to-end regulatory visibility of issues across the regulated terrain. There is therefore a question on whether the EC (and ESMA) are a sufficient regulator for the EU credit rating landscape, and in particular, the UK.

Behind the scenes, these questions centre on the power and influence of the regulator and the scope to drive real change without suffering from the legitimacy questions highlighted above. More research needs to be carried out in this area.

7.5.4 Sufficiently skilled regulator?

Participants depicted regulators as *'toothless bulldogs'* suggesting that they either lacked the means to enforce the regulations or were technically incapable of doing so. Consequently, the proposed regulations were said to be '*founded on shaky ground*' insinuating that the regulatory basis was not firm. This could be a result of lack of grasp of the real issues in the market by a regulator who was perceived to be removed from the ground. Alternatively, it could be that the real regulatory drivers were perceived to be at odds with those perceived by the interviewed market participants. There was a feeling that the regulations were populist as '*regulators had run off with the headlines*.' This suggested political motives as possible real drivers behind the EC regulatory proposals (Brand, 2005; Khademian, 1992).

IN2 expressed concern on the EC regulations and the potential for interference by regulators:

> *"I would be sceptical of regulations coming out of Europe as I'm sceptical of Basel III, Basel II or Basel I they didn't really do anything. You either have more capital or less but as to the correct level, I don't know. I think I would be more concerned that there is the potential for interference from regulatory bodies in the operations of rating agencies"*

The insinuation from the above sentiments were that in micro-regulating the operations of CRAs, regulators could compromise their independence and efficiency. Such effects could undermine the workings of the market with detrimental outcomes. The skills of regulators as relating to the specific EC regulatory environment were questioned by market participants who viewed such regulators as '*out of touch*' and possibly '*missing the point*.' It is therefore questionable whether the regulatory skills were appropriately matched to the regulatory task in the EU ratings industry and in particular, the UK securities market.

7.5.5 Fair, accessible and open regulatory framework

The depiction of the regulatory efforts as "*box-ticking*" and "*window-dressing*" suggested that market participants did not consider the regulatory efforts to be genuine. Perhaps more telling was the view that '*regulators are out of touch*' or that some regulatory proposals were '*entirely for the birds*' suggesting that the regulations were not perceived to be accessible as they were conceived in an abstract fashion, removed from the operational issues on the ground. By being '*only in the minds of politicians*' participants were expressing an inaccessibility of the regulatory proposals, possibly disowning the alleged drivers and proposed benefits. This inaccessibility suggested that the EC regulations were perceived to be exogenous as opposed to being endogenous (Becker, 1985; Ellig, 1991). Regulations were perceived to be narrowly conceived and therefore inequitable and possibly unfair. Against this background therefore, the EC regulations were perceived to fail the fairness, accessibility and openness test.

7.5.6 Accountability

The concept of accountability portrays regulators as directly answerable to the bodies giving them the regulatory mandate. In democratic dispensations, this is usually the electorate. Elected legislators can therefore be voted in or out by their electorates based on how their policy-making is perceived by the electorates. The strong sentiments expressed by market participants suggested that perhaps the regulatory process was not sufficiently accountable to those regulated. This may have been exacerbated by the supra national nature of the EC as a policy-making organ of the European Union.

Because of its non-hierarchical nature (Richardson, 1996), the EC is not directly elected by those it regulates. Consequently, there is no direct accountability of the regulator to those it regulates. Rather, the regulator is legitimised by a supra-national structure whose form is contested (Bufacchi, 1994; Radaelli, 1997). The characterisation of the regulations as '*going overboard*' suggests that participants felt that the regulations were exceeding their previously understood mandate. In the case of such a hegemonic regulator, participants' voices would be drowned in attempting to be heard across the 27 EU member states. On the basis of participants' perceptions, the regulations therefore fail the accountability test.

7.5.7 Micro level reach

According to the framework adapted from Baldwin et al. (2012) and Davies (2003) above, good regulations need a firm grasp of issues at a micro level. This covers firm-specific prudential measures as well as corporate governance issues. One of the touted regulatory aims was to strengthen corporate governance of credit rating agencies as well as ensure the elimination of conflicts of interests.

Seemingly, the drivers to enhance transparency through additional disclosure may go to some length in improving corporate governance but it is not as yet clear how firm-specific supervision can be operationalized. Seemingly, the EC has concentrated on the big picture, leaving finer details to local market contracted regulatory agents to address. This is the point where the delivery of the new regulatory regime may face challenges as it may differ depending on what structures exist in individual markets to effectively handle this. More research will need to be carried out to review ESMA's ability to effectively supervise at local levels.

7.5.8 Macro level reach

The macro level focus of the EC regulations is largely regional, concerning itself with issues in the EU. This has metaphorically been depicted by the boundaries and fences metaphors which symbolise containment and scope. This may both be a strength as well as a weakness. Focusing on the EU allows for containment of the regulatory issues within the region, allowing for the regulatory process to be localised and enforced in a harmonised way.

The fact that a regional approach is carried out in a globalised world is perhaps a weakness as there may be loopholes in the international system allowing for regulatory arbitrage (Dothan, 2008; Lannoo, 2009). Such a situation may result in regulatory tourism and portray the EU as an unattractive investment destination with stringent securities regulations hampering free market operations. The lack of equivalent regulatory bodies across different global jurisdictions makes it difficult to ensure a co-ordinated regulatory approach internationally (IOSCO Technical Committee, 2004). The formation of regional regulatory bodies in an otherwise global market is a subject worthy of further investigation. In evaluating the EC regulations, a more pervasive question emerges on whether crises can in effect be prevented and if so, whether regulations are an appropriate tool for doing this. This is discussed below.

7.6 Can crises be prevented

One of the aims of the EC regulations was to curb further escalation of the crisis by ensuring that there was a system holding CRAs to account in the EU. In attempting to achieve this, there was a view that regulators were trying to design a fool-proof regulatory system. A question may be proffered here on whether it is possible to completely prevent crises through proactive regulation (Davies, 2003; Eichengreen & Bordo, 2002). In their study, Eichengreen & Bordo (2002) argued that modern financial systems were twice as likely to fail as their pre-1914 counterparts. This suggested that by their design, modern financial architectures were prone to crises. Following on from this logic, regulators can minimise the impact of crises but cannot completely prevent them. Further, too prescriptive regulatory approaches may hamper creativity and innovation, which are cornerstones of modern financial markets.

7.7 Chapter Summary

This chapter analysed data comprising metaphor and non-metaphor data sets encapsulating study participants' perceptions of the impact of the EC CRA regulations on the operations of the UK securities market. Linkages were made to extant literature in credit ratings and regulation. The 25 non-metaphor groups and the 77 metaphors were streamlined resulting in 8 broad data categories summarising the study findings. The 8 categories were presented in metaphoric language following the metaphor analysis approach adopted in this study but they contained findings from the non-metaphor data as well. The discussion highlighted pertinent issues related to the regulation of CRAs in the EU. Firstly, there were strong reactions towards the regulations with allegations that the regulations were ill-conceived and likely to cause further imbalances through unintended consequences. Some of the regulatory objectives were said to be self-defeating as they were not only unattainable but if implemented could deliver negative outcomes.

A case in point was the objective of increasing competition which if achieved could fuel ratings inflation as CRAs competitively vied for business by providing optimistic ratings. Further, there were insinuations that regulators had not fully grasped the workings of the ratings market and did not evidence understanding the real drivers behind the choice of CRAs by issuers. This point was underscored by CRA1 who argued that:

> *"You look at governing documentation from a lot of funds, take the insurers for example, they have hard-coded into their investment guidelines ratings from S&P, Moody's or Fitch and suddenly having a wealth of competitors would be difficult for those kinds of investors I think. I agree competition is good for investors, more choice for investors is better but then again is it better on price or quality, hopefully both, given a choice would they prefer price or quality? I don't know, we have 100 years of history of this system working the way it has, if that sort of changes, that's a big change"*

Despite laying out clear regulatory proposals, the future role of CRAs was not specified in the new regulatory order compelling CRAs to either fight for their survival or continue as normal assuming that their role had not changed. Analysis of data revealed insightful metaphoric conjectures of CRAs and how they related to other players in the ratings market. There were power issues at play between regulators and the regulated; between incumbent CRAs and new or prospective entrants as well as between CRAs as quasi-regulatory agents and the market. Regulation was aimed at curbing some of these powers and this could cause unease particularly if the end game was not made known. Various theoretical conceptions of credit ratings were reviewed. It was argued that traditional economic perspectives were rather too technical and potentially failed to highlight softer behavioural issues driving institutions and individuals in the ratings market.

Overall, the study concluded that viewing issues in the rating industry from the traditional economic perspective was not sufficient to unpick the behavioural and sociological issues at play in the industry. Consequently, the study employed the endogenous regulation theory (Becker 1983; 1985) to explore the need for a more inclusive regulatory approach encompassing the needs of various market participants. The endogenous approach to regulation viewed regulation as a socially-constructed negotiation.

This suggested that the strong sentiments coming from market participants with regards to the regulations may not have been necessarily negative, but rather, a keen interest to engage with the process and attempt to influence it from within. There were strong misgivings by study participants on the EC regulatory process, its aims and motivations. Participants were sceptical that the regulations would have adverse effects on the market, that regulators had not understood the market; that the regulatory approach was patchy on one hand and too broad on the other.

Regulations were said to be kneejerk and not particularly focused; too fluid and likely to cause instability as well as politically-motivated. To cap the discussion, the chapter evaluated the regulations against the adapted model featuring the tenets of good regulation. The EC regulations were deemed to fall short of the expectations characteristic of good regulations as espoused in the model. The next chapter offers concluding remarks, a review of the study objectives and suggested areas for possible future research.

Chapter Eight:

Conclusion and recommendations

8.0 Introduction

This chapter offers an overview of the study, covering key arguments presented in this thesis. Thereafter, a brief review of the study objectives is presented, evaluating the extent to which this study achieved each of the objectives before outlining the study contribution to knowledge. Recommendations for possible further research are offered before the study draws to a close. The section below begins the discussion by summarising the key arguments presented in the preceding chapters.

8.1 Overview of key arguments

Credit Rating Agencies play a crucial role in global securities markets, bridging the information asymmetry gaps between investors and issuers. This role sees CRAs providing credit-worthiness opinions to investors regarding investee companies. CRAs also provide a rating monitoring service, tracking the performance of rated entities and updating their ratings in line with changing prospects of rated entities. Because of information asymmetry, many investors have come to rely on CRAs for opinions on where to invest or pull out. Further, regulators have increasingly relied on, and embedded credit ratings into capital market adequacy guidelines. This role has seen CRAs' influences grow to be regarded as quasi-regulatory agents and arbiters of investment information globally.

As discussed in Section 1.1.6, notwithstanding the increased power of CRAs over both market participants and regulators, CRAs traditionally operated in a loosely-regulated environment in the EU. This fuelled concerns about CRAs' lack of accountability and unchecked power (Partnoy, 2009; White, 2009). While the SEC provided regulatory oversight on CRA operations in the USA, there was no equivalent regulatory framework in the European Union and or the UK. Instead, three EU market directives provided a framework for the oversight of CRAs, alongside the IOSCO self-regulation code. Concerns over the lack of regulation on CRAs were heightened when CRAs were deemed to have contributed to various corporate collapses and market failures by either failing to provide timely rating adjustments or providing inaccurate ratings (in the case of structured products). These alleged CRA failures led to increased calls for CRAs to be regulated, particularly in the EU (Crotty, 2009; Gupta, Mittal, & Bhalla, 2010; Pettit, Fitt, Orlov, & Kalsekar, 2004).

The aftermath of the 2007-8 global financial crisis triggered moves by the European Commission to initiate proceedings to regulate CRAs operating in the EU. Despite the introduction of regulation No. 1060/2009, new concerns emerged regarding the scope of the new regulations, their motivations, mandate as well as regulators' competences. Some of the concerns centred on the fact that the regulatory approach would not work (Staikouras, 2012); that the regulatory scope was too narrow (Utzig, 2010); that the regulatory approach was a kneejerk reaction and not well-thought through (Fisch, 2010), and that the new regulations could have adverse unintended effects on market operations (Avgouleas, 2009; White, 2010a). Notably, most of the concerns were highlighted at academic and policy levels, raising questions on whether those who worked with credit ratings shared similar concerns. To get an appreciation of the rating environment, a historical review of credit ratings was provided in Section 2.3. Key to the appraisal of credit ratings was the dynamic market environment within which CRAs operated. Initially, CRAs operated on an investor-pays model. Technological developments led to the easing of information exchanges which meant that credit ratings could easily be shared, compromising the CRA revenue model. CRAs subsequently moved to the issuer-pays model. The fact that CRAs were now commissioned and paid by the same organisations they rated raised questions of conflicts of interest, possible bias, threatening the quality and validity of credit ratings (Frost, 2007). At the centre of these concerns were CRAs' abilities to maintain an objective rating service while at the same time bidding for more business from the rated entities. The fact that CRAs operated in an oligopolistic market, insulated from external competition limited choices and further entrenched the powers of incumbent CRAs.

Various attempts to address lingering issues in the rating market proved futile as CRAs continued to be blamed for corporate collapses and market crises. Despite the increasing concerns about the role of CRAs' role in providing ratings for both regulatory and investment decision-making, no definitive regulatory positions were taken in the EU to address the problem. On the contrary, ratings were further embedded into such regulatory requirements as Basel II, leading to a paradoxical view of regulatory reliance on ratings juxtaposed to the lack of regulatory oversight of the ratings process (Partnoy 2001; 2010). Debates ensued, with divided opinions regarding whether there should be more or less securities regulation in the EU. The form and scope of regulation was also debated, with different theoretical postulations on what could work.

Previous studies on credit ratings largely took an economic theoretical perspective, focusing mainly on the efficacy of ratings, their technical nature, ratings quality, causality between ratings and other variables (Cantor & Packer, 1996; Kerwer, 2002). While these approaches provided useful insights into technical aspects of ratings, they downplayed the sociological and behavioural influences in the ratings environment. Further, the mechanistic view of ratings downplayed the subjective and softer aspects of credit ratings linked to sociological and behavioural issues. An appraisal of the issuer-pays model highlighted inherent behavioural motivations which could potentially sway decision-making within the ratings market, further strengthening the view that there were behavioural and sociological drivers at play around credit ratings. In analysing causes of various financial crises, Kamalodin (2011) argued that human behaviour underpinned all causes of crises, suggesting that this should be investigated alongside the traditional economic studies.

Attempting to fill the gap, this study argued that alternative perspectives on credit ratings and regulation would add richer insights into behavioural influences driving individual and institutional behaviours to explain the regulatory inertia that characterised the European credit rating landscape for such a long time. Consequently, a behavioural appraisal of the regulatory void in the EU raised pertinent questions around the motives of the different regulatory stakeholders and how such motives could have influenced the regulatory process and with what outcomes. A review of extant regulation theory literature highlighted a prevalent view of regulation as an exogenous force applied to rather passive regulated entities (Baldwin & Cave, 1999; Baldwin et al, 2012; Stigler, 1971). At the same time, the opposite view; the endogenous regulatory approach was reviewed (see for example Becker 1985), raising questions on whether such an approach could deliver different regulatory outcomes to the European Union credit rating landscape.

Extant literature on credit ratings revealed polarised conceptions of credit ratings; as quantifiable objective measures of default probabilities on one hand, vs. subjective opinions highly disclaimed by their issuers on the other. Despite these polarised views, there was evidence that rating users (both at market and regulatory levels) had over-relied on the use of credit ratings for investment decisions as well as regulatory policy formulation. This suggested possible lack of understanding of what ratings actually meant. The role of credit rating agencies was also contested.

Different conceptions of CRAs were reviewed; CRAs as gatekeepers; as information intermediaries; as quasi-regulators; as information brokers among others. At the core of these conceptions was the expectation of what different stakeholders had of CRAs, suggesting that there was no commonly agreed expectation. This lack of a clearly defined role of CRAs meant that stakeholders could not hold CRAs to account and neither could judge the quality of their work. Further, CRA methodologies were said to be complex and opaque, alienating stakeholders and remaining mystical and difficult to define. Consequently, despite growing criticisms of CRAs, they continued to operate without any regulatory oversight. Against this backdrop, the EC regulations were introduced following the 2007-8 crisis. The regulations however raised fresh concerns about their true motivations; their possible unintended consequences; whether they were thought-through; whether regulators were competent enough to address the issues identified in the market and whether regulation was in fact the optimal answer for the identified problems.

This study sought market participants' views on the perceived impact of the EC regulations in response to the questions raised above. Owing to the specialised nature of the ratings market, characterised by a few specialists operating in a closed professional environment, the study was qualitative and exploratory in nature, adopting an interpretivist approach to acknowledge the subjective impact that regulations could have on different groups of study participants.

Semi-structured interviews were used on a purposive and snowballed sample of participants drawn from issuers, investors, Other Interested Parties and representatives of CRAs. Data was collected through audio-recorded one-to-one interviews which were later transcribed and subsequently analysed. A total of 30 participants were interviewed.

Analysis of qualitative data required an open and flexible approach catering for emerging themes from the data. Pursuant to the exploratory nature of the study, the adopted analysis approach allowed for deep immersion into the data, nurturing emerging themes.

At the initial stages of the analysis process, a prevalent use of metaphors was detected, resulting in the analysis approach defaulting to metaphor analysis to uncover the underlying meanings behind participants' language usage in articulating their views about the EC regulations.

77 metaphors were identified from the interview transcripts. The metaphors were subsequently grouped into 8 thematic categories depicting various participants' reactions towards the regulations. A further analysis of the non-metaphoric data was conducted, yielding 25 emerging themes. These were further streamlined to further corroborate the emerging 8 metaphoric themed categories.

Overall, the study data suggested contested regulatory spaces, depicting power tensions between regulators and regulated entities. There was a view by participants that regulations were exogenously imposed, triggering resistance by market participants. Seemingly anti-regulation sentiments were raised by participants, suggesting that they felt insufficiently engaged at the regulatory conception stage. There were perceptions of masked changes in the market, suggesting that rather than address real market issues, there was a perception of false realities and illusory changes. Regulatory motives were questioned, with alleged political drivers suspected to be driving the regulatory process. Regulatory competence, legitimacy, regulatory form and scope were questioned, with suspicions that the regulations were reactive and not well-thought through.

The sentiments above suggested that if market participants had been adequately engaged prior to the regulatory formulation process, some of the issues prompting regulatory revisions would have been identified and perhaps treated differently in the regulatory proposals. To corroborate this view, participants cited the frequent revisions in the regulatory clauses resulting in CRA1, CRA2 and CRA3. This, it was argued, further discredited regulators and questioned their competence in gauging market issues accurately. On this basis, regulatory proposals were said to be "*founded on shaky ground*" and likely to have unintended consequences instead of addressing legacy issues in the market.

An endogenous regulatory framework was offered as a possible explanation for participants' views, arguing that rather than being anti-regulation, participants were expressing a desire to endogenously engage regulators to maximise future regulatory payoffs and minimise future regulatory burdens. Endogenous regulation is a form of smart regulation fostering active engagement and communication between different stakeholders to the regulatory process resulting in shared responsibilities. Exogenous regulatory approaches were said to generate conflicts and friction while their opposite, endogenous regulatory approaches tended towards conciliatory outcomes.

It was further argued that the nature of the EC as a regulator raised pertinent questions consistent with a legitimacy theoretical approach. Due to limitations on time and resources, the legitimacy theoretical view was not explored in more depth in this study, suggesting that future research could be carried out to investigate the legitimacy issues around the European Commission as a pan-European regulator. The next section reviews the study objectives, appraising the extent to which the objectives have been met by the study.

8.2 An overview of the study objective and questions

This study set out to investigate the perceived impact of the EC Credit Rating Agency regulations on UK-based market participants. Specifically, the study sought to answer three research questions:

1) How do market participants perceive EC regulations to be addressing legacy problems identified in the UK ratings industry?
2) What is the UK market participants' perceived impact of the EC regulatory changes on the UK securities market/UK Credit Ratings market?
3) With CRA funding models alleged to be central to problems in the ratings industry, what are the perceived alternative approaches that could equally address the problems identified in the UK ratings market; which ones are most preferred by the UK-based market participants?

Overall, participants felt that regulators were not in touch with a very dynamic and specialised market. Engagement with practitioners in this market was said to be crucial particularly as they knew more about this innovative and dynamic industry and therefore could offer meaningful contributions to the regulation formulating process. Participants were therefore critical of the exogenous regulatory approach allegedly adopted by the EC.

It was argued that this approach alienated regulated entities from meaningfully participating in the formulation of the regulations, resulting in an ineffective and patchy regulatory formulation process as discussed earlier in this study. The following sections detail how each question was addressed by the study.

8.2.1 Question 1: Perceived adequacy of the EC regulations

Participants largely felt that the regulations were reactive and did not seem to be well thought-through as evidenced by the constant revisions suggesting that the EC regulations were formulated in an ad hoc fashion. The regulatory agenda was viewed with suspicion, with participants arguing that the regulations were largely politically-motivated, aimed at legitimising politicians in a "*box-ticking*" regulatory framework that would not address market issues (Benston, 1998). Regulators were said to have missed the point in the essence of the regulations. Their regulatory mandate was questioned, together with their competence particularly given the loose structure of diverse individual competent, market-based authorities to provide front line regulatory supervision services on behalf of ESMA. On this basis, it was felt that in their current form, the EC regulations were not adequate to address market problems. Further, the legal mandate of the regulator (ESMA) was said to be compromised by their non-Majoritarian nature and lack of a legitimate electoral mandate in each of the member states.

There were divided opinions on the regulatory scope. On one hand, some participants argued that the regulatory scope was too broad, applying a "*one size fits all*" approach and missing out on the finer market details that were key. This, it was argued, would negatively impact the effectiveness of the regulations across the disparate EU member states. On the other hand, some participants argued that the EU-centric regulatory approach, and the fact that the focus was on CRAs, meant that the regulations were missing other key market players who were connected to CRAs in a systemic environment. These polarised views were in themselves symbolic of the hazy regulatory proposals which were said to ironically lack accountability.

On the effectiveness of the regulations, there was a feeling that regulations in their current form could not increase competition as the competitive drivers lay outside rating agencies themselves. Regulators were therefore said to be missing the point on competition. On the question of investor protection, it was not immediately clear how additional disclosure would be operationalised to further enhance investor protection. In particular, participants were concerned about the possible resource requirements to deal with the additionally disclosed information.

There was a question as well on who would use the additional information – was the market assumed to be intelligent enough to consume and decipher the additional disclosures? CRA1 particularly queried this and argued:

> *"…but on the other hand when you ask for vast amounts of data, does anyone really get through it? Even with the best will in the world I would say No!"*

Improving corporate governance of rating agencies was good in principle but seemingly lacked sufficient operational detail. It was not immediately clear how such an objective would be implemented and monitored effectively and to what effect. There were concerns raised that some suggested governance proposals could detrimentally affect the operation of CRAs, particularly new and smaller entrants. Examples of such proposals included the mandatory rotation of CRAs and / or analysts, disclosure requirements among others. These required significant resources and could work against the regulators' attempts to encourage competition. The study therefore successfully addressed the objective of eliciting participants' perceptions on the adequacy of the EC regulations.

Analysis of the study data raised questions on why participants' ideas were not used to inform the regulatory process seeing that they were clear about what they thought could or could not work. The study opted to adopt a behavioural approach in evaluating participants' contributions. This was in contrast to the traditional economic theoretical perspectives largely adopted in previous studies. The behavioural and sociological approaches allowed for an evaluation of the motives and influences of the various players involved in the credit rating agency market. Participants' reactions towards the EC regulations and in particular, the concerns raised prompted the study to investigate approaches that involve participants in formulating regulations (endogenous approaches) vs. approaches that treat regulation as externally imposed on those regulated.

This analysis led the study to the endogenous vs. exogenous regulatory approaches. Further questions were raised regarding the legitimacy of the EC as a regulator, suggesting that further research could be carried out using legitimacy theory to investigate the mandate of the EC in different member states. The conclusion from the study findings was that the EC regulations had taken a narrow focus, were exogenously premised and thus had little buy-in from those regulated. The regulatory focus was perceived to be narrow as opposed to be holistic.

This question was thus comprehensively addressed by the study findings. The section below considers the second study question.

8.2.2 Question 2: Perceived impact of the EC regulations

Participants envisaged unintended consequences which could hamper market operations in the long term. There were fears of burdensome costs which could seriously compromise market efficiency and stifle competition, innovation and creativity. While the regulations sought to increase the number of CRAs and address lack of competition, participants perceived the current regulatory moves to be working against this regulatory objective. The prohibitive regulatory compliance costs were said to be acting as a barrier to entry, dissuading smaller would-be CRA entrants to consider registering to provide rating services in the EU. It was envisaged that such new and small agents would most likely not have the required resources to meet the regulatory requirements. The regulatory initiatives of increasing competition were thus perceived to be self-defeating as they were likely to induce a negative effect on competition by discouraging smaller new entrants.

Further, more players were argued to induce competitive behaviour among CRAs, and would most likely fuel ratings inflation, negatively affecting ratings quality. The argument was that similar to banks, an oligopolistic rating market offered the optimal rating services that had so far adequately met market needs. There were concerns that adding any more players would induce CRAs to issue favourable ratings in a bid to win more business and that such an effect could detrimentally impact on ratings quality. The choice of which CRA issuers used was said to be driven mainly by investors. This suggested that by merely introducing more CRAs, there was no guarantee that such CRAs would get business as investors preferred established household rating names.

There was therefore a "*catch-22 situation*" and unless there were specific regulatory sanctions compelling use of the new CRAs, participants did not envisage any such CRAs to get meaningful business unless they offered specialist niche services currently not offered by the incumbent CRAs. Participants questioned what they viewed to be simplistic proposals for example on analyst rotations which were aimed at addressing possible conflicts of interest. Participants argued that the proposals were impractical for smaller CRAs who could not have enough staff to rotate and would thus fall foul of the rules if they did not.

The proposal to rotate analysts thus worked against the regulatory objective of increasing CRA competition; was self-defeating and impractical for smaller CRAs. This was highlighted as a further indication that the EC CRA regulations had not been well thought-through.

The analysis of participants' responses again suggested that if regulators had extensively involved market participants and taken on-board their reactions, a lot of the regulatory revisions and turnarounds would have possibly been avoided. This again pitted the inclusive regulatory formulation processes against the exogenous approaches currently pursued by the regulators. The endogenous regulatory approach seemed the most optimal approach particularly given the fact that the rating agency market is specialised with market participants who potentially know more about what goes on in the market than regulators. In such situations, the regulators can get better outcomes by involving those regulated hence the recommendation of an endogenous regulatory approach. The study therefore successfully addressed the requirements of the second question, looking at the perceived impact of the EC regulations.

8.2.3 Question 3: Proposed alternative approaches

The issuer-pays model was said to be conflicted, necessitating the exploration of other possible alternatives in its place. Asked for possible alternative funding models for CRAs, participants were divided between retaining the current issuer-pays model, adopting an investor-pays model or adopting a central, publicly-funded rating model. Questioned further, it was eventually agreed that the issuer-pays model was fraught with challenges as highlighted in this study and therefore needed to be improved or replaced by more viable models if these could be found. The investor-pays model was said to be equally conflicted and could result in problems such as free riding, problems in the identification and recognition of new start-up issuers who would be below investors' radars and thus would struggle to get anyone to commission ratings on them if they were not known. It was argued that this was the original model in the first place and the fact that it was abandoned before was ample evidence that it could not be sustained in its original form. Improvements were therefore suggested but not specified.

The last model to be considered was the publicly-funded model. This was proposed to be a central, publicly-funded repository for all rating needs. Any issuers requiring rating services would register their interests with this body which would in turn allocate such ratings to CRAs on its list, ensuring an equitable distribution of business but also considering CRAs' competences and geographic coverage. This way, CRAs would not have any allegiance to issuing entities or investors, eliminating conflicts of interest and promoting CRA independence. A similar model was proposed by Fennell & Medvedev (2012) who termed it the platform model. Their proposal left questions though on the specific operational details of how such a central entity would run; the criteria for allocating rating bids; its supervision among other concerns. This proposed model is worthy of further research to test its viability. Based on the above, the study successfully explored the research aim and delivered on the research questions stated above. The section below reflects on the study contribution to knowledge.

8.3 Study contribution to knowledge

An investigation of the perceived impact of the European Commission credit rating agency regulations using more behavioural-oriented approaches brings new perspectives to an area traditionally viewed using more economic-oriented models. The study therefore makes several contributions as discussed below.

Straddling the domains of economic regulation and credit rating agencies, the study expands literature in the two areas, presenting participants' concerns about an alienating exogenous regulatory approach. The exogenous approach assumed a passive and somewhat inactive role of regulated entities resulting in the perceptions of regulations being imposed. The study argued that this approach did not work well in an area where the regulated entities were specialists, potentially possessing more knowledge of the market and products than the regulators. Any attempts to impose regulations in this case could result in ineffective regulations that could be subverted by the market. Instead, the study proposed an endogenous regulatory approach, placing regulated entities within the regulatory conception process and giving them a prominent voice to inform the process and minimise regulatory burdens. The approach took a social-constitution of regulation approach (Malloy, 2010), treating the regulation of credit rating agencies as an endogenous activity as opposed to the traditional exogenous view.

The second contribution related to the use of metaphor analysis as a method for analysing market participants' reactions to the EC credit rating agency regulations. According to Oswick & Grant, (1996) and Cornelissen et al, (2008) the use of metaphors in organisational studies was said to be rather limited. The authors encouraged more studies in this area employing metaphors to give new perspectives to the field. This study responded to that call by employing the use of inductive analysis of metaphors, innovatively conceptualising perceived issues in the regulation of credit rating agencies in metaphoric terms and helping induce vivid conceptions of possible solutions using a new metaphoric approach.

Theoretically, the study proposed an alternative view to the traditional economic oriented approach of investigating issues in credit ratings, instead, advocating the adopting of a behavioural and sociological perspective to better illuminate the individual and organisational influences shaping players in the credit ratings market. This approach employed the use of the endogenous regulation theory (Becker 1985; Ellig, 1991) to examine the motivations and reactions of market participants to the European Commission regulatory proposals. This approach allowed for new insights on the perceived impact of the EC regulations and was a break from the typically economic-oriented and technical approaches used in the past in investigating credit rating agencies and their ratings.

At a practical level, the study offered insights on issues said to have been overlooked by regulators in formulating the new EC regulations. The study therefore contributed to on-going debates about practical issues that need to be taken into consideration in revised future versions of regulations. Further, the study highlighted the need to involve and embrace market participants' views as they are the experts with a closer understanding of the practicalities of the regulatory issues in a dynamic and specialist area. This contributed to an enhanced understanding of the relationships between regulatory initiatives at policy level and the practical understanding of market participants.

8.4 Study Limitations

This study had four main limitations which offered scope for possible future research. Firstly, the study findings did not delineate between CRAs' performance in issuing initial ratings and subsequent rating adjustments. In reality, CRA performance on the two areas has been different hence in retrospect, a clear delineation should have been sought in respect of the two areas. Secondly, while the study provided an empirical account of UK-based market participants' perceptions of the impact of the EC regulations on the UK securities market, the study only provided a snapshot view at a point in time, spanning the three year duration of the study. The fluid nature of the CRA regulations may see the rating landscape changing quickly. Already, at the time of writing this thesis, the EC CRA regulations had seen three major revisions since their inception in 2009. This evidenced the evolving nature of the regulatory issues, the volatile climate and changing regulatory drivers. This meant that by the time the study was concluded, issues in the rating industry may have changed significantly. Notwithstanding the dynamic nature of the rating market issues, the insights drawn from the study regarding participants' overall views of regulation remain helpful even though the regulatory landscape may have changed. Such views will help inform future regulatory considerations in the credit rating market. It would be interesting if a follow up study was conducted later to see whether participants' views would have changed significantly.

The third study limitation emanated from the nature of the study participants, who were mostly members of the Association of Corporate Treasurers. The contributions expressed may have been guarded, representing the official line of their membership body. Non-members of the ACT were excluded from the sample and this may skew results somewhat. The purposive sampling approach and the subsequent snowball sampling potentially limited participants to a small circle, further limiting the potential sample. Notwithstanding this, the ratings market is relatively small and there is no evidence that widening the sampling frame would have yielded significantly diverse participants with sufficient knowledge of the credit rating industry.

Further, as the study came not long after the financial crisis where CRAs had been vilified for their alleged contribution to the crisis, views expressed may have been influenced by the heightened attention to both CRAs and the regulation thereof. Future studies could investigate views of broader groups beyond members of the ACT to see if such views resonate across different participant groups.

Lastly, the focus on UK-based market participants' views, while dealing with pan European Union regulations made it difficult to isolate the UK from the broader EU market and delineate regulatory effects. Consequently, some concerns expressed may apply to both the UK as well as the broader EU market. While the UK-centric approach to the study allowed for a contained, manageable sample, further research could be conducted on other EU countries to determine if participants share the same views expressed by UK-based participants in this study or whether market differences may give different outcomes.

8.5 Possible areas for future research

In addition to some of the possible research areas highlighted in 8.4 above, a number of areas emerged which however lay outside the scope of this study and hence could not be explored further. As discussed above, CRAs performed differently in issuing initial ratings versus providing on-going rating adjustments. As this study did not consider these two areas individually, future research could be carried out to investigate participants' views on the two areas.

The sentiments raised by participants concerning engagement with the regulatory process present an area that needs to be investigated further. In particular, the nature of consultation by the European Commission ahead of the enactment of the regulations, the scope of the consultation, the level of engagement (responses) by the market participants as well as the responsiveness of the regulator to the submitted participants' responses deserve further scrutiny, in light of this study's findings. This would validate or disprove potential claims of regulators consulting when decisions had already been taken.

The proposed alternative revenue models for CRAs need further investigation to test the viability of the proposed models and ensure that whatever is proposed, does not pose further unintended consequences to the market. As this was outside the scope of this study, the proposed model was not explored in depth.

Lastly, the effectiveness of the proposed regulations and the regulation framework need review to gauge how well they work considering the fact that the regulatory environment is evolving and it is difficult to fully evaluate the effectiveness of the regulations owing to the constant revisions. Further reviews of the effectiveness of the regulations can be done once the regulations have been allowed ample time to work.

8.6 Concluding remarks and recommendations

The study of UK-based market participants' perceptions of the regulatory impact of the EC CRA regulations revealed strong reactions of market participants towards the regulations. There are significant implications towards future regulatory amendments. If participants who are directly affected by the regulations do not perceive the regulator to be doing a good job, this erodes market confidence and potentially undermines the regulators' mandate in the market. Further, the sentiments raise questions on how well the consultation exercise was carried out prior to the regulations being enacted. Without cooperation from the regulated entities, the regulator will find it difficult to effectively regulate.

The regulatory efforts were visualised as fluid and swinging like a pendulum, suggesting about-turns in the regulation formulation process. While this may demonstrate responsiveness to changes in the market, it does not inspire confidence among the regulated entities.

The constant regulatory about-turns suggest a trial-and-error approach where perhaps things may not have been sufficiently scoped out before the enactment of the requisite regulations. At practice level, the study therefore makes recommendations as follows:

1) That regulators revisit the original / revised objectives to test these with market participants to ensure all possible impacts are anticipated and catered for,

2) That the market level regulatory remit be re-considered to ensure there are adequate structures and sufficient resources at local levels to allow for the effective delivery of regulatory tasks on behalf of the central regulator, (ESMA).

At a theoretical level, the study recognised that the attempt to analyse regulatory issues from an economic perspective was rather limited within the scope of this study.

The recommendation therefore is that the theoretical approach to investigating regulation be broadened to encompass not just the economic aspects of regulation, but the behavioural and sociological aspects as well. The use of metaphor analysis on issues in the regulation of credit rating agencies allowed for a visualisation of market participants' views in vivid imagery that allowed for new approaches to investigating phenomena in this area and hopefully this trend will continue particularly as the regulations are embedded and continue to evolve. The recommendation is that further studies using metaphor analysis be conducted in the evolving CRA regulatory landscape and in broader securities studies.

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Appendices

Appendix 1: Participant Information Sheet

Study title

Credit Rating Agencies: Regulatory changes and market participants' perspectives

You have been selected to take part in a research study to capture your views on the recently gazetted European Union, (EU) regulatory reforms targeted at regulating Credit Rating Agencies, (CRAs). The information below gives you details of the proposed study to enable you to decide whether after going through the information you want to proceed and take part in the interview or not. Before you decide whether or not to take part, it is important for you to understand why the research is being carried out and what it will involve. Please take time to read the following sections carefully.

What is the purpose of the study?

This study is being carried out to find out what different market participants think of the new EU regulations aimed at Credit Rating Agencies. Key to the questions to be asked is the need to establish what effect the regulations will have in addressing previously identified problems in the credit rating market. Some questions will elicit views on how CRAs are run and regulated to find out whether this meets the needs of today's global market. The study is being carried out as part of the researcher's 3-year PhD research project.

Why have I been invited to participate?

Participants to this study are drawn from people who work in and with Credit Rating Agencies. You have been chosen to participate because of your close association with this area. It is believed you may be able to share some important views about the proposed regulatory reforms and implications thereof.

Do I have to take part?

Participation is entirely voluntary. This information sheet is designed to give you an overview of what the study is about and what it will involve so that you can decide whether to take part or not. If you do decide to take part, please sign the attached Consent Form. Preferably, the interview will be audio-recorded for accuracy, speed and to facilitate a smoother interviewee-interviewer interaction. If you are uncomfortable with the interview being audio-recorded, please indicate on the Consent Form and the interviewer will take brief notes instead. If for any reason, you change your mind after agreeing to participate, you are still free to withdraw at any time and without giving a reason.

What will happen to me if I take part?

The interview will involve responding to questions posed to you by the researcher. There are no wrong or correct answers. What is important are your views. The entire interview will last between 30 minutes to an hour.

What are the possible disadvantages and risks of taking part?

Participating in the interview will involve about an hour of your time. Your identity and contribution will be anonymised and all data kept confidential within the limitations of the law. Although reference to you or your organisation will be anonymised but there is a possibility that certain assertions may be identifiable with certain institutions as the breadth of participants is limited.

What are the possible benefits of taking part?

The area of Credit Rating Agencies has been mired in controversy, particularly regarding the role of CRAs in the recent financial crisis. The new EU regulations have been introduced to restore confidence in the market and address previously identified problems. This study will help shed light on the reactions of market participants to these regulations. Results of the study will help inform future policy developments.

Will what I say in this study be kept confidential?

The study is being conducted on a confidential basis and none of the study's findings will be attributed to an individual or their companies. The interview files will be password-protected and kept safe at university computers in accordance to the Oxford Brookes University's Policy on Academic Integrity. In line with the University's policy, the data generated in the course of the research must be kept securely in electronic form for a period of up to five years after the completion of a research project.

What should I do if I want to take part?

Attached to your letter of invitation is this Information sheet and the Consent Form. After reading the Information Sheet, please indicate whether or not you want to participate in the interview by completing and signing the attached ***Consent Form***. If you are happy to continue, you also need to indicate (on the Consent Form) whether you are happy for the interview to be audio-recorded or not. Please send the signed Consent Form in the enclosed self-addressed envelope and post it back to the researcher who will contact you to arrange interview dates and times. Alternatively, if you have received the invitation by email, please send your response by return email, indicating whether or not you want to take part in the study by completing and sending back the attached Consent Form.

What will happen to the results of the research study?

The results of the interview will be used for the researcher's PhD thesis and some parts may be used for publishing papers in this area. Either way, no reference will be made to you or your company. You can request to receive an electronic copy of the thesis or publications when these become available.

Who is organising and funding the research?

This research is being carried out as part of a PhD studentship in the Accounting, Governance & Information Management, (AGIM) Department at Oxford Brookes University Business School.

Who has reviewed the study?

This research has been approved by the Oxford Brookes University Research Ethics Committee.

Contact details for Further Information

For further information about this study, please contact **Tabani Ndlovu**, xxxxxxx@brookes.ac.uk, Tel. xxxxxxxxxxx or alternatively, if you have any concerns about the way in which the study has been conducted, please contact the Chair of the University Research Ethics Committee on ethics@brookes.ac.uk.

Thank you

Your participation in this study is greatly appreciated

Appendix 2: Consent Form

Full title of Project: ***Credit Rating Agencies: Regulatory changes and market participants' perspectives***

Researcher: *Tabani Ndlovu, PhD Student, Oxford Brookes University Business School*

Email: tndlovu@brookes.ac.uk

Please tick box

1. I confirm that I have read and understand the information sheet for the above study and have had the opportunity to ask questions. ☐
2. I understand that my participation is voluntary and that I am free to withdraw at any time, without giving reason. ☐
3. I agree to take part in the above study. ☐

Please tick box

	Yes	**No**
4. I agree to the interview being audio recorded	☐	☐
5. I agree to the use of anonymised quotes in publications	☐	☐
6. I agree that my data gathered in this study may be stored (after it has been anonymised) in a specialist data centre and may be used for future research.	☐	☐

______________________	______________	______________________
Name of Participant	Date	Signature

Tabani Ndlovu		
______________________	______________	______________________
Name of Researcher	Date	Signature

Appendix 3: Broad interview themes / guide

As the interviews will be semi-structured, specific questions will vary depending on whether the interviewee is an issuer, regulator, CRA representative. Questions will evolve to reflect the responses of the different interviewees in a semi-structured setting but will be based on the following themes:

1. **Preliminary Questions**
   - Background and role within organisation
   - Experience of working with CRAs / ratings
   - Role of Credit Rating Agencies
   - Opinions on CRAs / establish if CRAs linked to crisis and whether this justifies regulation, regulatory approach etc

2. **Perceived impact of regulation**

3. **Perceived role of regulation in the securities market**
   - Perceived triggers of the EC regulations
   - Perceptions on the EC CRA regulations and their impact
   - Extent to which EC regulations perceived to address causes of the 2007-8 crisis

4. **Proposed remedies to address ratings market issues**
   - Potential alternative CRA funding models
   - Views on alternative regulatory approaches

Appendix 4: Typical interview questions

The following were the typical questions posed to interview participants. As the study followed a semi-structured approach, the questions were flexibly presented, not necessarily following the same order. The questions were tailored to suit participants' backgrounds.

Typical questions for investors - Objectives

1. To determine if the new regulations will change investors' perceptions of / relationships with CRAs
2. To find out investors' perceptions of the effects of the new regulations in the ratings market and their confidence on how well the regulations address legacy problems in the industry
3. To elicit investors' preferences and rationale on the choice between regulation and self-regulation
4. To find out if there have been any behavioural changes among market participants post the crisis or as a result of the new regulations

No.	Question	Objective
1	What is your role / involvement with Credit Rating Agencies?	Intro
2	Have there been any ratings-related regulatory challenges affecting your role? What are they? If not, do you foresee any ratings-related regulatory challenges which may affect your role moving forward? What is likely to trigger this?	Intro
3	What use do you (does your organisation) make of ratings? a. *Are credit ratings part of your investment guidelines?* b. *Have the guidelines changed since the crisis?* c. *How does your organisation treat structured finance ratings?* d. *Does it matter which CRA provides the ratings?* e. *Has your use of ratings changed since the crisis, e.g. more reliance on internal analysis?* f. *Would you consider using ratings from smaller (investor-funded) agencies?*	Intro 1/ 2/4
4	Have you come across any unsolicited ratings recently? If yes, have they been marked as unsolicited? How do you perceive unsolicited ratings?	1/4
5	Are you aware of the new EC regulations for Credit Rating Agencies?	Intro
6	How effective has been the regulation / supervision of CRAs prior to the crisis / new EC rules?	2/3/4
7	What is your reaction to the new European Commission CRA regulatory reforms? a. *Is formal regulation necessary or would a code of conduct be better?* b. *Is the new EU regulation of CRAs the right way to regulate them?*	2/3
8	What is likely to change in the way you relate with CRAs as a result of the new regulations? a. *Will you continue to use ratings?* b. *Will you continue to use the same rating agencies?* c. *Have the new regulations hampered the way you and your industry work? If so, what exactly has changed and what are the implications for your industry?* d. *Have the new regulations enhanced the way your company / industry work? If so what exactly has changed and what will it mean to your company/ industry?*	1/2/4
9	Are CRAs the appropriate vehicle for providing ratings? If not, what alternative do you think could fulfil ratings requirements?	
10	Are there any areas that remain unaddressed by the new regulations? What more should be done?	2/4
11	In your view, what is the likely impact of the new EC regulations on the ratings market both locally and globally?	1/2/3/4
12	Is the current funding model for CRAs appropriate, i.e. that the issuer pays? If not, who should pay? Advantages/disadvantages of other funding models?	1 /4
13	Do you think CRAs have changed since the crisis? In what ways? Is this positive change? What has necessitated the change? What more should they do?	1/4
14	The EU Commission is considering the creation of a European CRA. Do you think this is a good idea? Would you like to see a rating from them? Could it replace a rating from S&P /Moody's/Fitch?	2/4
15	Should there be more competition in the ratings market? Why?	2/4
16	The new CRA regulations aim to increase transparency. How will you use additional information to achieve this? What are the implications of the additional disclosed information in terms of costs, skills, time etc? and how will this impact your decision making / due diligence?	1/2/4
17	One of the aims of the CRA regulations is improved investor protection, do you feel safer under the new regulations? What makes you feel safer? If not, why not?	1/2
18	The new regulations aim to improve CRA supervision. In your view, do they provide a sufficient supervisory framework for CRAs in the EU? Globally? – why / why not?	2
19	Who else would you recommend for further information on CRA operations and the ratings market?	

Typical questions for CRAs – objectives

1. To find out CRAs' perceptions of how the new regulations will impact CRAs and other market participants
2. To find out whether or not CRAs have changed their practices post the crisis and why
3. To elicit CRAs' preferences between regulation and self-regulation and their rationale
4. To gauge CRAs' confidence on whether the new regulations address any legacy problems in the ratings market

No.	Question	Objective
1	What is your role / what do you do?	Intro
2	How do you see the function of CRAs post the crisis and following the new EC regulations?	Intro
3	What are the issues / challenges in the ratings market? *a. How have these evolved since the crisis?*	Intro
4	How effective has been the regulation / supervision of CRAs prior to crisis? Is this likely to change?	Intro /4
5	What would you like to see changed in the governance/regulation of CRAs and why?	Intro /4
6	Are you aware of the new EC regulations for Credit Rating Agencies?	Intro
7	What is your reaction to the new EC CRA regulatory reforms? *a. Is formal regulation necessary or would a code of conduct be better?* *b. Is the regulation prescriptive or does it allow for flexibility?* *c. Is the new EU regulation of CRAs the right way to regulate them?*	1/3
8	How are the regulations likely to change in the way your company / industry operates? *a. Will ratings continue to be used as before?* *b. Will your company's market share / customer base change?* *c. Have the new regulations hampered the way you and your industry work? If so, what exactly has changed & what are the implications for your company/ industry?* d. *Have the new regulations enhanced the way your company / industry work? If so what exactly has changed and what will it mean to your company/ industry?* e. *What specific changes have been made (/ may be made) in your company as a result of the new regulations? And with what effect?*	1/2
9	In your view, what specific issues do the regulations address?	1/2/4
10	Are there any areas that remain unaddressed by the new regulations?	4
11	Are CRAs the appropriate vehicle for providing ratings? If not, what alternative do you think could fulfil the same need?	1/2/3
12	What problems do you think the new regulations may pose in *a. The ratings market in general* *b. The operations of other market participants* *c. The global workings of the ratings market*	4
13	Is the current funding model for CRAs appropriate, i.e. that the issuer pays? If not, who should pay? Advantages/disadvantages of other funding models?	1/2/4
14	Have you as CRAs changed the way you work since the crisis? In what ways? What has necessitated the change? Is there more that you feel CRAs should be doing?	2/4
15	The European Commission is considering the creation of a European CRA. Do you think this is a good idea? What chance do you think the CRA stands in winning business away from S&P / Moody's/Fitch?	1/2/4
16	The new regulations aim to increase competition in the ratings market. Should there be more competition in the ratings market? Why?	1/2/4
17	The new regulations aim to increase investor protection, through transparency and disclosure, how well do you think this will protect investors?	1/4
18	Do the new EC regulations provide any tensions between your global / US operations and your EU work? If so, what are the tensions/conflicts	1/4
19	How will the additional disclosure requirements affect your business?	1/2/4
20	What will be the costs associated with implementing the new regulatory requirements in the EU? What impacts do these have on the viability of the EU market?	1/2/4
21	One of the new regulations' aim is to provide a single regulatory authority in the EU. Is this a better option for your organisation/industry or would you have preferred country-based supervision?	1/4
22	What are the implications of the obligation for issuers of structured finance instruments to provide access to information not only to the CRA they appoint, but to all other interested CRAs?	1/2/4
23	Do you think European and international legislation rely too heavily on ratings by CRAs?	1/4
24	The new EC regulations also aim to improve corporate governance within CRAs. What changes will this bring to your organisation and what will be the impact?	1/2/4
25	What are the implications of the EU registration requirements? Are these welcome? Why / why not?	1/2/4
26	Who else would you recommend for further information on CRA operations and the ratings market?	

Typical questions for OIPs – objectives

1. To determine if the new regulations will change the way in which CRAs are perceived
2. To find out OIPs' perceptions of how the new regulations will impact different market participants and whether they effectively address legacy issues in the ratings market
3. To elicit OIPs' preferences between regulation and self-regulation
4. To find out if OIPs believe there have been / will be behavioural/practice changes in the ratings market

No.	Question	Objective
1	What is your role / involvement with Credit Rating Agencies?	Intro
2	Have there been any ratings-related regulatory challenges affecting the ratings market? If so, what are they? If not, do you foresee any ratings-related regulatory challenges which may affect the market moving forward? What is likely to trigger this?	Intro
3	What use do you (does your organisation) make of ratings?	Intro 1/4
4	What are the issues / challenges in the ratings market and what is their cause? a. *How have these evolved since the crisis?*	Intro
5	How effective has been CRA regulation / supervision prior to crisis? Is this likely to change?	Intro
6	What would you like to see changed in the governance/regulation of CRAs and why?	Intro
7	Are you aware of the new EC regulations for Credit Rating Agencies?	Intro
8	What is your reaction to the new EC CRA regulatory reforms? a. *Is formal regulation necessary or would a code of conduct be better?* b. *Is the new EU regulation of CRAs the right way to regulate them?* a. *How well do you think the regulations will sit alongside global / international regulations?*	1/2/3
9	What is likely to change in market participants' relationships with CRAs due to the new regulations? a. *Will ratings continue to be used?* b. *Will the same rating agencies continue to dominate the market?* c. *Have the new regulations hampered the way the ratings industry works? If so, what exactly has deteriorated and what are the implications for the industry?* d. *Have the new regulations enhanced the way the industry works? If so what exactly has changed and what will this mean to the industry?*	1/2/3/4
10	In your view, what specific issues do the regulations address? E.g. *conflict of interest, transparency, CRA funding model or Competition*	2/4
11	Are there any areas that remain unaddressed by the new regulations?	2/4
12	What do you think are the likely impacts of the new regulations on: a. *The ratings market in general* b. *The operations of other market participants* c. *The global workings and coordination of regulations in the ratings market*	1/2/4
13	Is the current funding model for CRAs appropriate, i.e. that the issuer pays? If not, who should pay? Advantages/disadvantages of other funding models?	1/2/4
14	Do you think CRAs have changed since the crisis? In what ways? Should they be doing more?	1/4
15	Have you come across any unsolicited ratings recently? If yes, have they been marked as unsolicited? How do you perceive unsolicited ratings?	1/2/4
16	The EU Commission is considering the creation of a European CRA. What is your reaction to that?	1/4
17	Are CRAs the appropriate vehicle for providing ratings? If not, what alternative would you suggest?	1/2/3
18	The new regulations aim to increase competition in the ratings market. Is there need for more competition in the ratings market? Why?	2/3
19	How well do you think the single EU regulatory authority will work in supervising CRAs across EU member states. Do you think a country-by country supervisory framework would have been better or not?	1/2/4
20	What do you think of the additional information that CRAs have to disclose? Will this increase transparency and improve competition as intended?	1/2/4
21	The new regulations forbid CRAs from carrying out certain consultancy services to issuers they rate (as well as other measures to eradicate conflicts of interests) How well do you think this will work?	1/2/4

Typical questions for OIPs – objectives

1. To determine if the new regulations will affect the use of ratings together with issuers' relationships with CRAs
2. To find out issuers' perceptions of how the new regulations will impact them and other market participants and how well the new regulations address legacy problems in the market
3. To elicit issuers' preferences between regulation and self-regulation
4. To find out if there have been any behavioural changes or practices as a result of the reforms / crisis

No.	Question	Objective
1	What is your role / involvement with Credit Rating Agencies?	Intro
2	Have there been any ratings-related regulatory challenges affecting the ratings market? If so, what are they? If not, do you foresee any ratings-related regulatory challenges which may affect the market moving forward? What is likely to trigger this?	Intro
3	What use do you (does your organisation) make of ratings? a. *Who among the CRAs are you dealing with?* b. *Does it matter which CRA you commission for your ratings?* c. *Would you consider using ratings from smaller (investor-funded) agencies?* d. *Is there a special business manager dealing with fee negotiations or is the analyst dealing with these?* e. *Have you noticed any changes in the CRAs' relationship management post the crisis?*	1/4
4	Are you aware of the new EC regulations for Credit Rating Agencies?	Intro
5	How effective has been the regulation / supervision of CRAs prior to the new EC rules?	2
6	What would you like to see changed in the governance/regulation of CRAs and why?	4
7	What is your reaction to the new EU CRA regulatory reforms? c. *Is formal regulation necessary or would a code of conduct be better?* d. *Is the new EU regulation of CRAs the right way to regulate them?* e. *How enforceable are the new regulations, in the UK, EU, and Globally – by whom?* f. *Are you issuing more or less debt since the crisis? / since the new regulations?* g. *How important is the rating for the success of the issue? (before and after the crisis)?* h. *Has the importance of ratings changed since the crisis?*	1/2/3/4
8	What is likely to change in the way you relate to CRAs as a result of the new regulations? a. *Will you continue to use ratings?* b. *Will you continue to use the same ratings agencies?* c. *Have the new regulations hampered the way you and your industry work? If so, what exactly has deteriorated and what is the implication for your industry?* d. *Have the new regulations enhanced the way your company / industry works? If so what exactly has changed and what will it mean to your company/ industry?*	1/2/4
9	What specific issues do the regulations address e.g. conflict of interest, transparency?	2/4
10	Are there any areas that remain unaddressed by the new regulations?	2/4
11	What problems do you think the new regulations may pose in a. *The ratings market in general (locally, regionally and globally)* b. *The operations of other market participants*	1/2/4
12	Is the current funding model for CRAs appropriate, i.e. that the issuer pays? If not, who should pay? Advantages/disadvantages of other funding models?	1/2/4
13	Do you think CRAs have changed since the crisis? In what ways? Is this positive change? What has necessitated the change? What more should they do?	4
14	Have you come across any unsolicited ratings recently? If yes, have they been marked as unsolicited? How do you perceive unsolicited ratings?	2/4
15	The EU Commission is considering the creation of a European CRA. Do you think this is a good idea? Would you commission a rating from them? If no, what would they have to do that you would consider it?	1/2/4
16	One of the new regulation's aims is to increase competition. Is there need for more competition? Would you commission a new CRA if new ones came in the market?	1/2/4
17	Are CRAs the appropriate vehicle for providing ratings? If not, what alternative would you suggest?	1/2/3
18	To improve transparency, the new regulations call for more disclosure, what use will your organisation make of the additional CRA disclosure? What are the resource implications for processing this?	1/2/4
19	Who else would you recommend for further information on CRA operations and the ratings market?	

Thank you for your participation

Appendix 5: Sample of an interview transcript

The following is a sample of an interview transcript from the study

TN: Thank you very much for agreeing to help out with my study. Just to mention that my study is being carried out on an anonymous basis, so my final report won't mention either your name or that of your organisation.

IS9: That's ok, I have no problem with that.

TN: Firstly, do you mind giving me an overview of how your role interfaces with rating agencies?

IS9: I am group treasure of xxx and one of my responsibilities is managing the relationship with rating agencies. So the two that effectively cover us and who we have a relationship with and where we pay for the rating are Moody's and S&P but also Fitch.

TN: Is there any reason why you use the two mainly?

IS9: They are in my opinion and I think in the opinion of the market, the two main credit rating agencies. I've made this comment before to several people, we only use rating agencies because our bond investors who we access funding from, will demand a credit rating from S&P and Moody's.

TN: Do you have any specific guidelines that stipulate these two?

IS9: No, we don't, we could change, there is no policy. It is just that we believe that it's best to have two ratings which in order to optimise funding costs and the best two rating agencies we have in the market are S&P and Moody's at the moment. Once again, I think if our bond investors and creditors came back and said that they value the opinion of another rating agency in favour of Moody's and or S&P, then I think there would be a good chance for us to move to that rating agency. It's all driven by what our creditors and bond investors demand in terms of providing us with funding and credit.

TN: That's understandable. I'm not sure whether you are aware of the European Commission rating agency regulations?

IS9: Sort of, you may want to remind me of any particular points you want to discuss.

TN: One of the EC regulatory objectives is to encourage competition in the ratings market. To what extent do you think regulation can effectively achieve that particularly when players like yourselves seem to be guided by bond holders in terms of the choice of rating agencies?

IS9: I don't think it can. I don't think this is a market where regulation can work, it is driven by the market and what is valued and what isn't valued. As I said, I think if our investors were sufficiently confident in their own credit analysis that they saw little value of official credit ratings from Moody's, S&P, or Fitch or whoever, then we wouldn't want a credit rating, for us it only serves a purpose which is to reduce our funding costs and allow other counterparties in the industry to provide us credit by entering into agreements, and that's all it is and if other entities entered the market, maybe a rating agency that's established by the banks that would be good but only to the point where investors are sufficiently confident in that new entity that they effectively demand of us that we have that rating.

TN: On that point, the EC has mooted on an idea of introducing an EC-sponsored agency. If such an agency came to be, would you use it?

IS9: Well, in many ways it's the same answer I have given previously, if the investing institutions had sufficient confidence in that rating agency that they valued the opinions of that agency and therefore by valuing the opinions of the agency they would ask us to use that agency to reduce our funding costs then yes, but it's all driven by what the investor perceives to be some value in terms of the opinions given. If it was deemed to be a politically-driven sort of institution where they weren't prepared to give arms-length, independent ratings analysis on things like sovereign credits or large banks because of the potential economic fallouts of that, then there would be no confidence in that agency and therefore it would be of little value. So it would have to be completely independent and arm's length. If there was any interference from the EU in terms of the analysis or opinions given on companies, banks or sovereigns, then that agency would have no credibility and therefore wouldn't have sufficient value.

TN: It sounds like new agencies need a bit of track record to attract customers but to get that track record, they need customers..

IS9: Yes, that's a catch-22 situation! I think the only way it might work was if there was some regulation in position of the ratings such that all bonds that were issued must have a rating from that agency and therefore that might lead to a position where it could over time establish sufficient credibility that that requirement could fall away and the value of that rating could stand in its own right.

TN: But would that be interpreted by the market that such a rating agency would be the mouthpiece of the regulatory authorities?

IS9: Oh to begin with, it certainly would, but over a period of maybe 3-5 years, you could get the EU moving away from that agency in terms of putting in place various features that show that the agency is independent and therefore by breaking away and displaying independence then they may come to a point that that institution would be valued in its own right rather than being seen as the mouthpiece of the EU.

TN: One of the issues highlighted in the new regulations relates to conflicts of interest between issuers and rating agencies. Would you have any comments on that?

IS9: It's an obvious concern but I actually do think that the rating agencies handle that quite well, we never ever speak to, we are not allowed to, the analysts would never have a conversation with us regarding fees and that's always dealt with by a separate part of the rating agency. I do have quite a degree of confidence that there are strict barriers between those two parts of the organisation, the organisation that's dealing with the invoicing and fee structure and the analysts is completely separate. So yes, in practice I do think the Chinese walls and the barriers that the rating agencies establish internally do to me appear to be working quite well.

TN: What would your response be to a statement that says that perhaps the Chinese walls may work relatively well at lower levels of the organisation but perhaps taller people at higher levels may be able to peep through?

IS9: Yes, I think that's always a concern. I think that's a concern in banking as well regarding Chinese walls. I've actually more confidence of that working within credit rating agencies than I have within the banks to be quite honest.

TN: The regulations aim to foster some behavioural changes in the market and I wondered whether you have observed any changes?

IS9: No

TN: Is it business as usual then?

IS9: It is, I don't see how introducing regulations can change anything. It's a service that's either valued or it isn't when it comes down to it. If the rating agencies aren't doing their job, then the investors will not demand a rating of the company or the bond and therefore it will fall away naturally. So therefore I think, I don't see how regulations can actually change that. If anything, the EU coming out and dismissing the downgrading of peripheral European countries, dismissing it as if it doesn't matter, the rating agencies basically don't know what they are doing, then that really undermines the EU established agency.

TN: Except if they are insinuating that perhaps the incumbent CRAs have some biases?

IS9: Yes, I don't think that's necessarily the case, the fact that S&P has downgraded the US, I don't think there is any significant bias towards the US or against EU corporations or the EU sovereign credits. I actually think the American or US view of the Euro is fairly sound and that there it is a sound experiment. It's just a question of when it breaks up rather than if, so I think in the EU there is a determination, a will, to keep the Euro together which isn't backed up by evidence and the facts and it takes the US are seeing this more clearly than European countries to be quite honest.

TN: There is an idea of a possible skills issue from a regulatory perspective in terms of understanding what's happening in the ratings market. How skilled do you thing the regulators are in grappling with the issues in the ratings market?

IS9: No, I couldn't really comment on that

TN: Just a follow-on point on that. Some previous participants talked of a revolving door principle where skills flow from industry to the regulators and vice versa, do you see that happening in the ratings market?

IS9: No, personally, once again, I have not seen it. It doesn't mean that it isn't happening.

TN: I just wanted to pick your brains, what is a rating? This question arises from the allegation that perhaps there was over reliance on ratings by investors who may not have done enough due diligence of their own

IS9: I think that's probably true, yes, I think that's why rating agencies exist because some institutions and corporates haven't got the resources to actually do a thorough enough due diligence on the credit of the institutions they have exposures to. We are in that position, xxx as a company relies very much on the ratings of banks and other large corporates that we do business with in order to establish credit ratings. I also think that is true but I also think that if you are going to do credit analysis yourself as an institution, then you need substantial resources to actually do that. There is no point in giving that to people within your organisation who are doing it on a part-time basis when they haven't got the required skills and experience to actually do it. So I think that's why rating agencies exist because a lot of companies haven't got the resources to do that due diligence.

TN: In your view, do you think rating agencies do an effective job in that area?

IS9: I think they do, but I also think that they have the position in the market to do a much better job. I actually think the better analysts exist within banks and the investing community but that the rating agencies are in a much stronger position because certainly for most institutions they rate, they get access to forward-looking information and access to senior management that can discuss strategy with them and that's something we wouldn't do with our banking analysts. With banking analysts, we would only give them historic information, we would not give them any forward-looking information. With rating agencies they get access to that, we share our three year projections with rating agencies which is extremely valuable information for analysts to have but I don't think they use that information as effectively as they should.

TN: Is that incompetence or deliberate?

IS9: I think its incompetence, it can't be deliberate, they,… can't deliberately ignore that. I think incompetence is too strong a word but I don't think they are as good as a typical analyst that exists within banks. I think that's down to their salary structure. I think you would find in terms of the revolving door, from an analyst point of view, it's a one-way door, you know, if analysts come into the rating agency are trained up, then if they are good analysts, they are poached by banks, that's certainly my experience that the better analysts do tend to go to banks who are willing to pay more. But you know, ultimately it's still the rating or the opinion of the rating agency that I would still value more than from a bank because of this access to forward looking projections that rating agencies get.

TN: When you look at a historical rating itself, wouldn't you say it's a lagging indicator rather than a forward-looking indicator?

IS9: It should be forward-looking, it obviously won't, if you look at a rating opinion, they will focus on historical factors because obviously they can't publish the forward-looking projections we've given them, one of the things we say to them is that we'll let you see our forward-looking projections but for obvious reasons we can't allow you to publish them. They can't publish the fact that may believe that the cash to debt ratio will increase or decrease in the next 12-24 months that would be publishing inside information effectively to all the market. So for understandable reasons that a rating agency opinion will focus in terms of what it reports on, on historic information but reading between the lines and the actual opinion will be more related to and more determined by those forward-looking projections than rating agencies are aware of from regular annual meetings or even more regular than that, meetings with management.

TN: One of the regulatory aims is to increase investor protection. Do you see any evidence of that in the market after the introduction of the regulations?

IS9: I see no real evidence of that, but once again if it's something that investors should be demanding, then again investors have a requirement from a rating agency they should be discussing that requirement, effectively demanding that rating agencies carry out certain criteria, certain processes when they do a credit rating opinion. I see no evidence of that really. I see the rating agencies changing and over the years they have become a lot more transparent in terms of what we have to do as a company or to maintaining a rating, they are displaying exactly ratios, what financial ratios we need to maintain at a given rating level but I'm not sure whether that's driven by regulation or driven by the fact that over the last 10 years or so, they haven't done a great job and are trying to improve because of market pressure rather than regulatory pressure.

TN: But isn't there an anomaly there in the sense that investors don't have a formal direct relationship with rating agencies; it is the issuers who do?

IS9: No, they don't but I think the rating agencies understand. It is a very strange relationship here. Obviously you've mentioned it. In terms of rating a corporate, the corporate pays for the rating, there is something there for the benefit of the investor, so I think the rating agency understand that it's vital that they give the investor what the investor wants because if the investor does decide that it's of no value, then business between the corporate and the rating agency would dry up. So where there is no formal relationship, I'm pretty sure that there is an

input into the rating agencies that investors have in terms of demanding certain practices, if there isn't, then rating agencies are certainly missing a trick there.

TN: One would have expected though that perhaps such an input would be more effective if it came through whoever pays the rating agencies don't you think?

IS9: Sorry, I didn't quite understand that, what was that point again?

TN: if you look at the flow of the money in this industry, it flows from investors to issuers and from issuers to rating agencies, it would be logical to assume that influence and power flows in a commensurate direction such that the influence on rating agencies would come from investors but through issuers as they have the lever to tighten should things don't work?

IS9: I don't think it works that way. I have never had any investor come to me and say can you help we really need the rating agencies to amend their reporting or include in their reporting any particular features or make any discussion I've never had a conversation with an investor regarding the reporting from a rating agency

TN: That's interesting, I don't want to labour on the point too much but I just wondered that since investors do not pay the rating agencies, what forum would they have to articulate their requirements and how effective would that be?

IS9: I think, I'm not sure but I think the rating agencies do have relationships with investors through various seminars that they hold, I do think they meet up with the investing community on quite a regular basis having discussions, having meetings, I don't think, well, maybe I don't know enough about it but I'd be surprised if there isn't communication between investors and rating agencies regarding how they see the ratings and how the ratings could be improved. I would think all the pressure in terms of updating amending ratings is coming from investors from some forum. There must be some mechanism whereby the rating agencies can pick up feedback from investors even though there isn't that fiduciary relationship between the investor and the rating agency.

TN: I'll certainly follow that point further, it sounds interesting

IS9: Yes, I think there must be, there must be ways, there must be some communication, interfaces there between rating agencies and investors. I'd be amazed if there isn't.

TN: What is your view on the regional approach of the EC regulations at a time when everything tends to be global?

IS9: In what respect, are we talking about the rating agency regulations?

TN: Yes, the EC rating agency regulations focusing

IS9: I think there has to be global coordination the world is far too global now to have the EU establishing a regulatory set up that isn't consistent with the rest of the world. I think there has to be consistency here.

TN: I know you list across different markets, have you come across any challenges associated with different regulatory requirements when it comes to the use of ratings?

IS9: No, not from a ratings point of view, no.

TN: What do you think of the use of the same symbols to rate sovereigns, corporates and bonds when the underlying asset structure implications are different?

IS9: I don't have a problem with it, I think it works quite well and the market understands that that's the denomination, the way they symbolise the credit ratings. It's ok to then compare a financial institution with a sovereign and a corporate if the rating symbols are the same, so I don't have a problem with that, I think it's quite useful.

TN: In terms of the way you work, have you seen any changes post the crisis?

IS9: No, I'm certainly aware that the rating agencies are more systematic in their approach now, that they obviously have internal guidelines and some regulations to make sure that they seeing corporates on a more regular basis and also performing their analysis within certain timescales and they have obviously improved their act in terms of making sure that there is more discipline on the ratings in terms of how its carried out, how regularly they see management, how quickly they produce their reports, what the reports contain etc. So I see quite a bit more discipline from the rating agencies that has been introduced over the last 3 years. For us, we have continued largely as before, volumes continue to experience the normal fluctuations but no major changes as a result of the crisis.

TN: Has that change brought about any impact on resources from your end?

IS9: Not really, no, it's obviously a bit more rigorous, they require more information and perhaps more time to go through things but we haven't had to introduce any special extra resources for that. We have coped with the existing resources.

TN: What do you think is the motive behind the EC regulations on credit ratings?

IS9: I think it's not really holding any value existing rating system. I think within Europe there is maybe some value there value held from a rating....excuse me, can I just take my other phone, I won't be a sec.

TN: Sure, not a problem

IS9: .....I just think it doesn't like the ratings process and I wonder whether that is perhaps to do with the fact that Moody's and S&P are US agencies rather than European agencies, I'm not sure about that. They clearly don't have a great deal of regard for the existing, for the current rating agencies. I'm sure they did a terrible job during the 2008 crisis which to some extent is true, they didn't do a great job so they probably want to see some improvements in the process, which everybody wants, I don't think the rating agencies were doing a particularly great job but I don't think you improve that by introducing regulation. You improve that probably by getting investors to demand a better service.

TN: Would you do that by regulating the investors themselves?

IS9: Well, I don't think you do need to regulate the information the investors get. At the end of the day, it's a pretty sophisticated market, the investing community. I just think you need to explain to that market that they have got some powers to actually demand that rating agencies improve. If anything, I think there is a case for the investors to set up a separate, an independent agency that can compete with Moody's and S&P if they don't value the... and investors clearly have concerns over the existing structure and the credibility and value of the existing rating agencies. They claim that they criticised the rating agencies consistently since 2008 and they clearly need to do something if they are not satisfied with them.

TN: If you were to place the blame for the 2008 financial crisis, where would you place it – rating agencies, issuers, investors?

IS9: Interesting, none of those, I don't think you can blame rating agencies for it. I don't think they have done a great job but I think it's a bit like blaming your fire alarm for your house burning down when you have been having fires inside the house. Obviously it could have been reported earlier, but it's not their fault. It's not issuers, all they have done is borrowed money when they have needed it. I think the blame actually; I know a lot of

people place the blame on banks. I think its government; governments across the developed world are to blame for the crisis we got ourselves in by taking on and allowing their nations to take on too much debt.

TN: Is that the regulatory side?

IS9: Yes, regulatory side but its governments rather than the.... I think it's not just a question of the government should have ensured there was more regulation on banks and more regulation on issuers and rating agencies. I think it probably is that governments have gone along very happily with the build-up of debt across both corporates and financial institutions and should have, I suppose introduced, set up a mechanism for regulation and none of them did. So it's not regulators themselves that are to be blamed because the regulators were not given the mandate to go out and spot the build-up of debt that was actually needed. Their governments could have given that mandate to regulators and they didn't. Because they were enjoying the growth that was coming from the build-up of debt without realising that at some point in the future, that debt has to be paid back. So I think governments are mainly.., even banks in this country, in the UK, only a year before this crisis happened, you had Gordon Brown standing up saying what a wonderful job the banks in the UK had been doing and what a national asset they were, less than 12 months before the crisis came!

TN: Which probably goes back to the point we discussed earlier that perhaps at government levels, there is perhaps less understanding of what is actually happening in the industry

IS9: yes

TN: If you were to change anything in this industry moving forward, what would you change?

IS9: I would like to see a new agency set up by the investing community, initially financed and supported by the investing community, whereby the investing community paid for the rating service. I'd like to see that set up. I don't necessarily think that the existing institutions are doing a great job I think there should be competition but that needs to be driven by the investors not by government so I would like to see a new competitor set up by the investors whereby the investors have that fiduciary relationship with the rating agency.

TN: Is that because you don't believe the current issuer-pays model is working effectively?

IS9: I don't think it's working as effectively as it could. Clearly there are still concerns over the quality of the ratings so I think it could certainly be improved.

TN: Is that linked in any way to the alleged conflicts of interest?

IS9: It could be, I'm not sure, but it could be one of the problems why the quality of ratings isn't higher

TN: Well, that was my last question, thank you very much for your time. If you like, I can circulate a copy of my final report to you.

IS9: Yes, I'd like to see that if possible